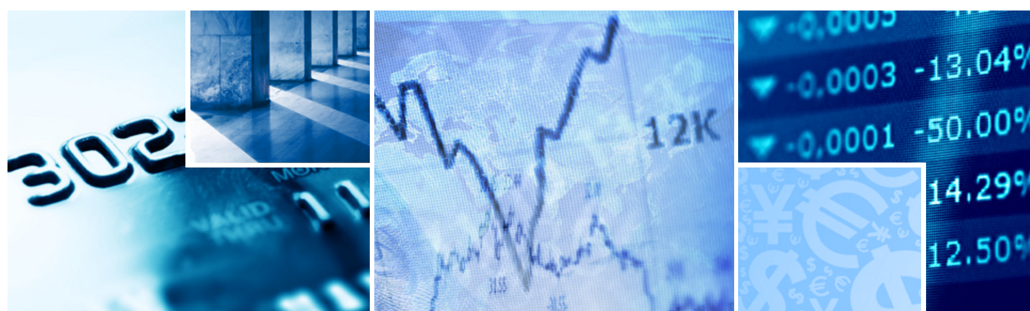
Overview and Analysis of Select Provisions of the ABI Chapter 11 Reform Commission Final Report and Recommendations

Part Three of Three

By Orrick Restructuring Group



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Earlier this year, Orrick's Restructuring team began a three-part look at the American Bankruptcy Institute's Chapter 11 Reform Report. In part one we looked at issues related to confirmation, valuation, financing and asset sales. Last month, in part two, we focused on modifications to the Bankruptcy Code's "safe harbors" for derivatives and other complex financial transactions. This final part focuses on a variety of critical issues: third party releases, rejection of collective bargaining agreements, professional compensation issues and treatment of executory contracts in bankruptcy.

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Third-Party Releases

Current Law

Generally, a third-party release provision in a plan extinguishes identified non-debtor parties from liability for claims or causes of action that third-parties may hold against them. Third-party releases—which usually cover parties such as the debtor's directors and officers, the official committee of unsecured creditors and its members, non-debtor plan sponsors and proponents, debtor-in-possession lenders and estate professionals—are typical in most chapter 11 plans, especially in cases of large-scale corporate bankruptcies. Third-party releases may be binding on parties that have consented to the release or voted for (or abstained from voting on) the plan and the release. They may also be non-consensual where parties are forced to release third-party claims by virtue of confirmation of the plan.

There is a split in authority as to whether third-party releases are permissible under the Bankruptcy Code. While most courts have held that third-party releases may be granted in certain circumstances, the Ninth and Tenth Circuits, and to some degree the Fifth Circuit, have found that Section 524(e) of the Bankruptcy Code generally precludes bankruptcy courts from discharging the liabilities of non-debtors. Moreover, the courts that do allow third-party releases have devised numerous legal standards and relevant factors to assess the propriety of granting such releases.

Commission Recommendation

The Commission has recommended that a debtor or plan proponent should be permitted to seek approval of consensual and non-consensual third-party releases in connection with the solicitation and confirmation of a plan, thereby resolving the split in authority. However, the release must be clearly and conspicuously highlighted and explained in the plan and the disclosure statement and must identify the proposed scope of, and parties to be covered by, the release.

The Commission observed that third-party releases are appropriate from a practical perspective since a "debtor may need the assistance of non-debtor parties to effect its reorganization" and such parties may be reluctant to contribute to the plan or the debtor's reorganization efforts if they might be exposed to liability. Report at 255. However, the Commission also recognized that "limiting creditors' recoveries to those provided under the plan may substantially change the nature of their rights against non-debtor parties, and in turn further reduce their overall recoveries." *Id.*

When determining the propriety of granting a non-consensual third-party release, the Commission recommends that a bankruptcy court should be guided by several factors derived from *In re Master Mort. Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994). Specifically, the court should consider and balance each of the following factors:

- the identity of interests between the debtor and the third party, including any indemnity relationship, and the impact on the estate of allowing continued claims against the third party;
- any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan;
- the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts;
- the level of creditor support for the plan; and
- the payments and protections otherwise available to creditors affected by the release.

In the case of parties that did not vote in favor of the plan, the Commission recommends that a court give significant weight to the last of these factors. The Commission also believes that a court should consider these factors when analyzing the propriety of releasing a debtor's affiliates pursuant to a chapter 11 plan.

Potential Impact

If the Commission's recommendations are adopted, we expect reduced forum shopping by debtors. With the possibility of third-party releases becoming subject to greater certainty, parties who may benefit from such a release may be willing to assume a more active role in a chapter 11 case.

Formalizing Process of Rejection of Collective Bargaining Agreements

Current Law

In the 1980s, Congress added section 1113 to the Bankruptcy Code. Section 1113 heightened the standards for rejection of a collective bargaining agreement beyond the business judgment standard that applies to rejection of most contracts under section 363 of the Bankruptcy Code.

Under section 1113 of the Bankruptcy Code, a court shall approve rejection of a CBA only if:

- the trustee has, prior to the hearing, (i) made a proposal to the employees' representative that details modifications in benefits necessary to permit an effective reorganization, and (ii) provided the employees' representative with all "relevant information necessary to evaluate the proposal";
- the employees' representative has refused to accept the proposal "without good cause"; and
- the balance of the equities favors rejection of the CBA.

Section 1113 also details timing around an effort to reject a CBA. The court shall schedule a hearing not later than 14 days after the debtor files a motion to reject and shall rule on the application within 30 days after commencement of the hearing (which time may be extended with the consent of both parties). If the court does not rule within 30 days (or an agreed extension), the debtor may terminate or alter any provisions of the CBA.

Commission Recommendation

The Commission notes that disputes over CBA rejection "can be time-consuming, expensive and litigious . . . [and] also can be emotionally charged and disruptive at key points in the chapter 11 process." Report at 156. The Commission also asserts that the current process provides little meaningful opportunity to negotiate modification of the CBA. Instead, "many debtors in possession viewed the bargaining required under the Bankruptcy Code as a means to the litigated end they desire." Report at 161. Therefore, the Commission has proposed several key changes to the process for rejection of a CBA.

- First, the debtor should request a preliminary conference regarding initiation of a section 1113 proceeding, in which the debtor must certify that it has provided the employees' representative with a written copy of its initial proposal;
- Second, the court should schedule a status conference to discuss the section 1113 process with the parties. The conference should permit the employees' representative sufficient time to review the proposal and meet and confer with the debtors to discuss a timetable for negotiations;
- Within 30 days of the initial request, the court should hold a status conference to discuss a timetable for negotiations, resolve any issues regarding disclosure of information, determine whether a mediator could assist, and discuss any other obstacles; and
- If the parties, after a reasonable time, cannot resolve their issues, the court shall hold a second status conference to assist in resolution and to set a hearing schedule, with the trial taking place within 180 days of the debtor's initial request.

The Commission also attempts to resolve a split legal question regarding the treatment of rejection damages under section 1113 of the Bankruptcy Code. The Commission states that rejection under section 1113 should give rise to rejection damages under section 365 of the Bankruptcy Code.

Potential Impact

These modifications, if accepted, would not alter radically the substance of section 1113 jurisprudence. However, they would make the negotiation—and ultimately rejection—process more formal. This should provide a more robust negotiation period for unions—thus likely providing employees with additional leverage in a negotiation.

Executory Contracts Under Section 365 of the Bankruptcy Code

Subject to court approval, a debtor may assume, assign, or reject any executory contract under section 365 of the Bankruptcy Code. The Commission addressed a number of issues related to exeucutory contracts. Below we discuss three: the definition of executory; the required performance by non-debtors during the bankruptcy; and the impact of rejection.

Definition of Executory Contract

Current Law

The term "executory contract," is not defined in the Bankruptcy Code. Courts have therefore adopted several different tests for determining what constitutes an executory contract. Of these, the most widely used is the "Countryman" definition, which defines an executory contract as one under which the obligations of both parties are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other. Over time, some courts have adapted the Countryman definition in various ways to overcome its perceived shortcomings.

Commission Recommendations

After considering a number of alternatives—including the possibility of eliminating the concept of executoriness from the Bankruptcy Code altogether—the Commission recommended that the Countryman definition be incorporated into the Bankruptcy Code. The Commission noted that a number of courts have found the Countryman definition to be a poor test of whether certain types of agreements are executory, specifically options, covenants not to compete, and oil and gas leases. One alternative to the Countryman definition, called the functional approach, focuses on whether the assumption or rejection of a contract would create a benefit for the bankruptcy estate and its creditors. The Commission rejected this approach, primarily out of concern that it too heavily favors the interests of debtors over the rights of non-debtors. The Commission also evaluated the exclusionary approach, which deems a contract to be executory if each party has unperformed obligations and the debtor's failure to perform eliminates its right to performance by the other party. Ultimately, the Commission concluded that, despite its limitations, the Countryman definition appropriately balances the rights of debtors and non-debtors to a contract, and the case law applying the definition is already well developed.

Potential Impact

Because the Countryman definition is already widely used, we do not expect much impact from this recommendation. If adopted, it should encourage more consistent treatment of executory contracts across jurisdictions. We also think it is unlikely that codifying the Countryman definition will significantly curtail the amount of litigation on this issue. Although debtors and their counterparties will have more certainty as to what test will apply, they will still need to establish whether a particular contract fits the Countryman definition.

Required Continued Performance by Non-Debtor to Executory Contract Post-Petition

Current Law

Section 362(a) of the Bankruptcy Code provides for a broad stay of litigation and lien enforcement against a debtor upon the filing of a bankruptcy petition. This stay is intended to provide the debtor with sufficient time, (i.e., a "breathing spell") to determine, among other things, which of its executory contracts and unexpired leases it should assume, assign or reject.

For non-debtors, this breathing spell often results in a performance gap between the Petition Date and the debtor's decision date. While the Bankruptcy Code addresses performance during this gap period for parties to non-residential real property leases, certain personal property leases and intellectual property licenses, it does not address the obligations for parties to executory contracts and unexpired leases. Courts often interpret this silence, coupled with the importance of the breathing spell, to mean that the contract remains enforceable by the debtor only. This interpretation leaves the non-debtor at a significant disadvantage.

Although the non-debtor is able to compel performance or a treatment decision under section

365 of the Bankruptcy Code, and can also request an administrative expense claim under section 503(b)(3) to the extent the debtor fails to perform any post-petition obligation, these avenues often take time to produce results. Moreover, case law differs as to whether a non-debtor can compel the cure of prepetition nonmonetary defaults before the debtor assumes such agreement.

Commission Recommendations

Recognizing the burden of the gap period on non-debtors, the Commission found that prior to the debtor's decision to assume, assign or reject an agreement, the non-debtor should be required to continue to perform under agreements necessary for the debtor's continued business, but only to the extent the debtor continues to pay for goods or services under those agreements. By paying for such goods and services, the debtor would not be subject to any modifications otherwise intended to be imposed on account of the bankruptcy, default or insolvency. The non-debtor would still have the ability to compel a decision on the agreement or post-petition performance thereunder but such performance would only be required where it was necessary to mitigate the harm to the non-debtor. The Commission also recommended that a debtor should not be required to cure prepetition nonmonetary defaults before assumption of an agreement where defaults are impossible to cure at the time of assumption.

Potential Impact

By providing certainty in connection with the post-petition obligations of parties to executory contracts and unexpired leases, we expect that the Commission's recommendations will reduce litigation and provide greater incentives for parties to settle disputes. Moreover, the Commission's recommendations provide non-debtors with additional avenues to obtain relief during the period between the Petition Date and the debtor's decision whether to assume, assign or reject the executory contract. This may provide non-debtors with additional bargaining power during settlement negotiations. On balance, because the Commission emphasized that the burden to require immediate post-petition performance should be high, it is unclear the extent to which these additional rights will sway the debtor during settlement.

Impact of Rejection of Executory Contracts

Current Law

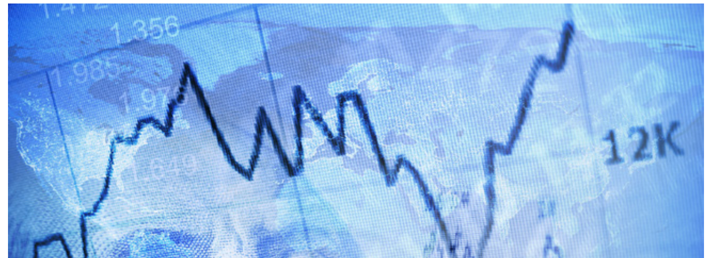
Section 365(g) of the Bankruptcy Code provides that when a debtor rejects an executory contract it breaches the contract; however, there are questions as to what rights the non-debtor has upon such a rejection. Specifically, bankruptcy courts often find that a non-debtor is unable to exercise all of the rights it bargained for under the contract. The non-debtor also loses any right to demand specific performance or enforce equitable remedies, and the non-debtor cannot continue to use property otherwise available to it under the terms of the contract. These courts reason that available remedies outside of bankruptcy must be limited in bankruptcy to ensure similarly situated creditors are not treated differently and debtors are provided with all of the benefits of the automatic stay.

Commission Recommendations

While the Commission agreed rejection should be viewed as a breach and not a termination of the executory contract, the Commission did not believe a non-debtor should be able to exercise all contractual remedies available to it upon this breach. In finding this, the Commission reasoned that federal law trumps the state law contract rights of the non-debtor.

Potential Impact

Once again, the Commission's conclusions are closely aligned with how courts currently treat rejection of executory contracts. However, the express limitations the Commission advocates (i.e., elimination of a non-debtor's right to seek specific performance and/or equitable or injunctive relief and the denial of post-petition retention or use of debtor property in accordance with the terms of the contract) work to the debtor's benefit. Specifically, if adopted, debtors will have one less thing to negotiate with their counterparties. This means less litigation but perhaps also a deterrent to doing business with distressed companies to the extent that non-debtors intend to rely on specific performance, equitable remedies, or continued use of property under the agreement for the operation of their business.



Professional Compensation

Current Law

Pursuant to section 327 of the Bankruptcy Code, a debtor must seek court approval to retain "disinterested" professionals to assist with its chapter 11 case. The fees of these retained professionals are subject to court approval after a determination of "reasonableness" under section 330 of the Bankruptcy Code. Upon a determination that, among other things, the fees were (i) reasonable, necessary or beneficial to the estate (11 U.S.C. § 330(a)(3)(C)), and (ii) the amount of time spent was commensurate with the complexity, nature and importance of the issue or task (11 U.S.C. § 330(a)(3)(D)), a court will usually approve payment of such fees out of estate funds.

Other parties in a chapter 11 case such as secured creditors, creditors who are parties to an agreement or settlement with the debtor, parties to intercreditor agreements, and *ad hoc* committees may also seek payment of professional fees and expenses from estate funds. The Bankruptcy Code does not subject these professionals' fees to the compensation standards of section 330. Rather, the request for payment is often part of an underlying bargain, a chapter 11 plan, or a court-approved settlement between the debtor and creditor for payment of professional fees out of estate funds.

Debtors in possession also often seek court approval to retain and compensate "ordinary course professionals" during the pendency of a chapter 11 case. These professionals do not consult or work on bankruptcy-related issues. Rather, they perform services that the debtor would have required outside the bankruptcy context. The process for retaining and paying these "ordinary course professionals" is less stringent than the process for retaining and paying chapter 11 professionals under sections 327 and 330 of the Bankruptcy Code. It typically requires the debtor to identify the specific or general types of professionals to be retained and to establish a cap that limits the amounts that can be paid to these entities out of estate funds during the chapter 11 case.

Commission Recommendations

To improve the transparency of the professional compensation process, the Commission proposes the following recommendations:

- A debtor's professionals should be clearly classified as either working on matters relating to the chapter 11 case (chapter 11 professionals) or on matters unrelated to the chapter 11 case (nonbankruptcy professionals).
- Only chapter 11 professionals should be subject to the retention standards in section 327 and to the disclosure of reasonableness standards for professionals' fees and expenses in section 330 of the Bankruptcy Code. Nonbankruptcy state laws governing many professions (e.g., accountants, financial advisors, consultants) are sufficient to protect the interests of the estate with respect to nonbankruptcy professionals.
- To the extent professionals representing secured creditors, creditors who are parties to agreements or settlements approved by the court, or *ad hoc* committees would be paid their fees and expenses from the estate, those fees and expenses should be subject to the reasonableness standards set forth in section 330(a) of the Bankruptcy Code. The Commission did not go so far as to recommend that these professionals' fees and expenses be subject to a fee application process, recognizing instead that the standard of review was more important than the form of the fee disclosures. To the extent the court disallows any professionals' fees and expenses under this standard, the creditor or ad hoc committee should not be permitted to seek reimbursement for disallowed fees from other stakeholders in the case.
- Professionals retained by the debtor in possession or any statutory committee should not be considered fiduciaries of the estate. Rather, those professionals' duties should run to their respective clients and be governed by applicable nonbankruptcy law.

- Courts and professionals are encouraged to use creative alternative billing arrangements (e.g., fixed-fees, flat-rates, unbundling of services with different prices for various aspects of cases, incorporate escalators or de-escalators in flat-rate fee arrangements) in lieu of the traditional hourly billing model. Courts should not review alternative fee arrangements under the lodestar method, which is applicable to the hourly billing model.

Potential Impact

If the Commission's recommendations are adopted, we do not expect there to be a material impact on the professional compensation process for chapter 11 professionals. The biggest impact would be felt by professionals representing secured creditors, creditors who are parties to agreements or settlements approved by the court, or *ad hoc* committees. Such professionals' fees would now be subject to a formal "reasonableness" standard under the Bankruptcy Code. Typically, such fees are contractually but not statutorily subject to a reasonableness standard today.

Finally, the Commission's forward-thinking approach with respect to alternative billing arrangements and the move away from the traditional hours-based billing model reflects a long-expected but slow-developing change in legal fees in the market.

Contact Us

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