Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Expedited Bankruptcies Are Cause For Concern

By **Brian Shaw and David Doyle** (June 9, 2021, 5:06 PM EDT)

Brian Shaw

David Doyle

The U.S. Trustee's Office, the bankruptcy watchdog for the U.S. Department of Justice, recently reaffirmed its general opposition to so-called shotgun bankruptcy cases, or Chapter 11 bankruptcy cases in which the debtor seeks to either confirm a plan or sell substantially all its assets in a matter of weeks, or less, after the petition date.

The U.S. trustee views these high-speed cases as an abuse of the Bankruptcy Code, permitting debtors and lenders to obtain the benefits of a sale or confirmation order approved under the Bankruptcy Code without the attendant burdens and disclosures prescribed by the same.

The abuse, the U.S. trustee notes, is exacerbated because the truncated process usually only reflects the demands of a select few to the procedural exclusion of all others. And as noted below, the U.S. trustee's concern is legitimate, especially in those cases where it appears that the exigent circumstances were largely of the debtors' and/or lenders' own making.

One common form of shotgun bankruptcy is the prepackaged Chapter 11.

In a prepackaged case, the debtor negotiates and solicits votes in favor of a Chapter 11 plan of reorganization prior to the filing of the case as provided for in Section 1125(g) of the Bankruptcy Code.[1] The case itself is filed solely for the purpose of obtaining confirmation of the plan and to exit bankruptcy as quickly as possible, which if done so by the notice and hearing process prescribed in Rule 3017(a) should take no less than 28 days.[2]

Yet, often in the case of a prepackaged plan, the debtors and plan sponsors will also request to shorten the notice period for confirmation based on exigent circumstances that inevitably include the allegation that any "delay will kill the debtor."

If successful, the bankruptcy case can take a matter of days from start to finish — or even hours in some recent cases — and be far less expensive and risky than standard, or free fall, cases, in part because many of the interested parties who have the legal right to participate in a bankruptcy case have little to no time nor practical opportunity to do so.

Available data suggests that prepackaged bankruptcy filings have increased during the pandemic.[3] And not surprisingly, increased use of the prepackaged plan has triggered more attempts by debtors and lenders to shorten the amount of time in bankruptcy, and more corresponding objections from the U.S. Trustee's Office.

In In re: Guitar Center Inc.,[4] for instance, the debtors sought to limit the deadline to object to confirmation to 19 days after the bankruptcy case was filed.[5] The debtors explained that the largest impaired claimholders had already consented to confirmation, and that shortened notice would minimize any adverse effects of the Chapter 11 filing on the debtors' business.

The U.S. trustee objected to confirmation because the shortened objection deadline meant that a crucial plan supplement would not be made available until three days before the objection deadline,

ignoring "basic principles of due process in violation of the rights of creditors and other stakeholders."[6]

Nevertheless, the U.S. Bankruptcy Court for the Eastern District of Virginia entered the debtors' proposed scheduling order.[7]

In In re: HighPoint Resources Corp.,[8] the debtors completed plan solicitation prior to the filing of the bankruptcy case and sought confirmation only four days after the case was filed. The debtors noted that the plan had been accepted by over 99% of voting creditors and equity holders and that an abbreviated process would "reduce the potential damage to the debtors' business ... aris[ing] from the time spent in these chapter 11 cases."[9]

The U.S. Trustee's Office objected to the debtors' proposed schedule, arguing that they were "effectively proposing an ex parte Chapter 11" and noting there was no record of "immediate and irreparable harm" that justified the expedited process.[10]

Despite the objection, the U.S. Bankruptcy Court for the District of Delaware agreed to the debtors' proposed scheduling order.[11]

In perhaps the most notable example, In re: Belk Inc.,[12] the debtors sought a confirmation hearing just hours after the case was filed. The debtors explained that they had solicited votes on the plan prebankruptcy and 100% of voting claimholders had accepted, further citing the adverse effects that Chapter 11 filings could have on the debtors' business.[13]

The U.S. Trustee's Office objected:[14] The debtors "want to have their cake and eat it too by foisting obligations onto others before shouldering the responsibilities held by Court-supervised debtors-in-possession." The U.S. trustee argued that the plan, among other issues, contained improper nonconsensual third-party releases that were "unintelligible," noting that the release itself began with a "630-word sentence with 92 commas and five parentheticals."

Despite these concerns, however, the U.S. Bankruptcy Court for the Southern District of Texas confirmed the plan within 19 hours after the case was filed, blessing millions of dollars in transactions in a case lasting a single day.[15]

The rise of prepackaged bankruptcy cases coincides with the broader shift away from traditional reorganizations.

Claiming the same type of exigent circumstances used to justify shortening confirmation periods, such as the melting ice cube analogy, debtors have increasingly enlisted Chapter 11 to effectuate a quick — or shotgun — sale of the debtor's assets within the first weeks of the case, effectively achieving in what decades earlier could only be achieved in months or years: the sale of substantially all of the debtors assets free and clear and the payment of proceeds to secured creditors.

As noted by the ABI Commission to Study the Reform of Chapter 11, prior to the early 2000s, "a traditional chapter 11 sale process could take at least three months, if not more."[16]

The process typically involved "a thorough post petition marketing and auction process; sufficient opportunity for notice, objections, and hearings on both the auction process and sale transaction; and the closing of the sale."[17] The comprehensive process "instilled a certain level of confidence in the bankruptcy sale process, and resulted in the conclusion that the approved sale was in the best interests of the estate."[18]

Since then, however, the ABI Commission found that sale processes have become "much more abbreviated."[19] Although not prepackaged, the outcomes are often preordained by debtors and their lenders, with bankruptcy courts frequently entering sale orders within weeks of the bankruptcy filing.

With quick sales come the risk of a compromised auction process and a reduction of potential recoveries by unsecured creditors. In addition, these expedited sales frequently require the bankruptcy court to order not just auction procedures, but a myriad of findings regarding the validity of the secured lender's claim and limitations on investigations of liens and lender liability claims — all

within the first days of the bankruptcy case.

The U.S. Trustee's Office has opposed shotgun Section 363 sales for the same reasons it opposes rushed prepackaged plans. It believes both undermine fundamental tenets of the Bankruptcy Code — due process and transparency — essentially a meaningful opportunity for a party in interest to participate in a bankruptcy case if it chooses to do so. That right exists for the benefit of all parties in interest and not just a select few.

A sale of substantially all of a debtor's assets will impact all stakeholders and determine the likelihood and amount of any recovery on account of their claims. The traditional Chapter 11 process protects the interests of smaller stakeholders by requiring ample notice to creditors and other parties in interest if their rights will be affected, and by providing those parties with the ability to be heard in furtherance of those rights.

And most importantly, it increases accountability by enabling parties in interest to understand how the debtor is meeting its fiduciary obligations to all its creditor constituencies, not just its secured lenders.

However, if the process is truncated enough, those tenets become meaningless to the overwhelming majority of parties in interest — as there is neither time nor adequate information for them to protect their rights.

The U.S. trustee's concern is legitimate. Shotgun processes limit oversight by the bankruptcy court and the U.S. trustee, not to mention smaller stakeholders. Most commercial bankruptcy practitioners can appreciate this concern, as many of us have represented the proverbial little guy who has been cut out of a bankruptcy case because of a shotgun process in a foreign jurisdiction.

Moreover, the concern is one which the U.S. trustee is uniquely positioned to raise, and is raised on behalf of those parties in interest who do not have the ability to raise it themselves.

On the other hand, the code, the rules and the court's ability to adapt to variable circumstances, including the proverbial melting ice cube, are what enable the process to work. So, can they be reconciled? The answer is maybe, and we should try. Here are a few suggestions.

First, on the procedural side, learning from the pandemic, bankruptcy courts should continue to be liberal in allowing video court appearances and excusing local counsel requirements. If necessary, the burden of making video arrangements for hearings could be placed on the party that is asking for exigent relief.

Second, if a party is asking for a truncated sale or confirmation process, require the requesting party to go through its paces and prove its necessity with admissible evidence. Examine whether, like in Belk and HighPoint, the applicable notice periods were provided prebankruptcy.

It should not be acceptable for a debtor to be granted extraordinary relief merely because the effort needed to meet its burden will allegedly result in the debtor's demise. Rather, both the bankruptcy court and litigants should take their cue from the U.S. Court of Appeals for the Seventh Circuit's 2004 doctrine of necessity decision in In re: Kmart Corp.

There, the Seventh Circuit took issue with the debtors' failure to present and the court's failure to require any evidence beyond self-serving statements from the debtors to support their allegations that the requested critical vendor payments were necessary.[20] And if the court determines the exigent circumstances are of the debtors' own making, it should consider denying the extraordinary relief.

Finally, debtors and plan sponsors seeking to confirm a plan on an expedited basis must make a legitimate effort to provide some meaningful notice to its creditors and parties in interest.

And, if possible, they should do so prior to commencement of a prepackaged case — or both the proposed plan and bankruptcy procedure — in order to give those parties a meaningful opportunity to protect their rights, and then be able to justify that effort to the court.

Brian Shaw is a member at Cozen O'Connor and past president and past chairman of the American Bankruptcy Institute.

David Doyle is a member at the firm.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] All cites to "Section" shall be to sections of the Bankruptcy Code, 11 U.S.C. Section 101 et al and all cites to "Rules" shall be to the Federal Rules of Bankruptcy Procedure.

[2] Fed. R. Bankr. P. 3017(a).

[3] E.g., S&P Market Global Intelligence, "Coronavirus-era bankruptcy surge heavily favors reorganizing over liquidation" (April 1, 2020) (https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/coronavirus-era-bankruptcy-surge-heavily-favors-reorganizing-over-liquidation-63336513) (last accessed June 2, 2021) (reporting that "more prepackaged or prearranged bankruptcies also help explain the greater number of Chapter 11 bankruptcies in 2020").

[4] In re: Guitar Center Holdings Inc., Case No. 20-34656-KRH (Bankr. E.D. Va. Dec. 10, 2020).

[5] Id. at [D.I. 14].

[6] Id. at [D.I. 200].

[7] Id. at [D.I. 82].

[8] In re: HighPoint Resources Corp., Case No. 21-10565-CSS (Bankr. D. Del. Mar. 15, 2021).

[9] Id. at [D.I. 12].

[10] Id. at [D.I. 48].

[11] Id. at [D.I. 94].

[12] In re: Belk Inc., Case No. 21-30630 (Bankr. S.D. Tex. Fed. 23, 2021).

[13] Id. at [D.I. 14].

[14] [D.I. 44].

[15] [D.I. 61].

[16] American Bankruptcy Institute Commission to Study the Reform of Chapter 11, Final Report and Recommendations (2014) ("ABI Report") at 84.

[17] Id. at 84-85.

[18] Id. at 85.

[19] Id.

[20] In re Kmart Corp., 359 F.3d 866, 874 (7th Cir. 2004).