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The "Stipulated Asset Allocation" Model for a Non-consolidated Liquidating Chapter 11 Plan

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Practice & Procedure

Liquidating chapter 11 plans commonly provide for the creation of a state-law trust that succeeds to the debtor's assets and liabilities on the effective date of the plan and administers the assets for the benefit of creditors, who are the trust's beneficiaries. In a single-debtor case, the liquidating trustee's job is fairly straightforward: Find the assets, monetize them, pay administrative expenses and distribute the net proceeds to creditors in accordance with the Bankruptcy Code's priority scheme. Similarly, the trustee's fiduciary duties are well-defined: Maximize value, minimize expenses and administer the estate as expeditiously as possible.

A multi-debtor case adds another layer of complexity. Absent substantive consolidation of the debtors' estates,[1] intercompany claims and other disputes necessarily place each debtor and its creditors in an adverse posture with the other debtors and their creditors. Potential conflicts are numerous, and their resolution may affect creditor recoveries by altering the respective estates' assets available for distribution (*e.g.*, a dispute over the ownership of an asset, or the appropriate allocation of value for a shared asset) or aggregate liabilities (*e.g.*, a dispute over recharacterization of an intercompany "debt" as equity, or the proper allocation of shared overhead expenses). As a result, any fiduciary charged with administering multiple estates will likely encounter situations where maximizing value or minimizing expenses for one estate and its creditors will necessarily result in decreased value or added expenses for another estate and its creditors. Presented with such a conflict of interest, the fiduciary will have little choice but to seek outside help, which may take the form of a successor fiduciary for one or more estates, conflict counsel to act on behalf of each estate, or an interpleader or similar action whereby the matter will be submitted for impartial judicial determination.

The potential for debilitating inter-debtor conflicts of interest in jointly-administered chapter 11 cases is minimized by oversight by the creditors' committee (which is ordinarily selected from creditors of the various estates), the U.S. Trustee Program and the bankruptcy court, as well as by the transparency of the bankruptcy process and ability for creditors and other parties in interest to intervene and be heard on any matter in which their rights may be affected. In the early stages of chapter 11 proceedings, affiliated debtors-in-possession and their professionals can (and should) focus primarily on taking actions for the debtors' common benefit, leaving for another day the resolution of intercompany claims and other potential disputes. When the dust settles and it comes time to formulate a chapter 11 plan, however, inter-estate conflicts assume primary importance because their resolution will largely dictate the structure of the plan.

Alternatives for Resolving Inter-debtor Claims and Disputes

Where substantive consolidation is a viable option, it provides an easy solution. Intercompany claims are extinguished and other potential conflicts are mooted by the consolidation of the debtors' assets and liabilities. The consolidated estate is administered in the same manner as a single-debtor estate, which simplifies matters greatly for the liquidating trustee.

For purposes of this article, however, we assume that substantive consolidation is not a viable option, either because the applicable standard cannot be met,[2] or because other considerations militate against it. In this situation, the debtors must either settle their differences in the

[1] Substantive consolidation is an equitable remedy under federal common law that "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities which are erased)." *Genesis Health Ventures Inc. v. Stapleton (In re Genesis Health Ventures Inc.),* 402 F.3d 416, 423 (3d Cir. 2005).

[2] *See generally In re Owens Corning,* 419 F.3d 195 (3d Cir. 2005); *In re Augie/Restivo Baking Co.,* 860 F.2d 515 (2d Cir. 1988).

context of the plan via Bankruptcy Rule 9019 and Bankruptcy Code §1123(b)(3)(A), or permit intercompany claims and disputes to ride through confirmation of the plan for resolution by the plan trustee at a later date.

There are several advantages to addressing intercompany claims and disputes in the plan rather than deferring the resolution until the postconfirmation period. *First,* it permits administration of the plan by a single fiduciary, free from conflicts of interest that could otherwise delay plan administration and increase administrative expenses. *Second,* it provides transparency, an opportunity for creditors and other parties in interest to be heard in opposition (whether by simply voting their ballot or filing a formal pleading) and finality. *Third,* it avoids the delay and expense of litigating inter-estate conflicts to a judicial resolution.

Standard Applicable to Plan Settlements

The Supreme Court has long considered plan compromises "a normal part of the process of reorganization."[3] In evaluating a proposed compromise contained in a plan, bankruptcy courts apply the same "fair and equitable" standard applicable to settlements under Bankruptcy Rule 9019. *See, e.g., In re Exide Techs.,* 303 B.R. 48, 67 (Bankr. D. Del. 2003). To determine whether a settlement is fair and equitable, courts typically (though not exclusively) look to the following factors: (1) the probability of success in litigation; (2) the likely difficulties in collection (*i.e.,* for claims belonging to the estate); (3) the complexity of the litigation involved and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors. *See, e.g., Myers v. Martin (In re Martin),* 91 F.3d 389, 393 (3d Cir. 1996). The court's role in this inquiry is not to decide the numerous issues of law and fact implicated by the proposed settlement, but rather to "canvass the issues and see whether the settlement falls below the lowest point in the range of reasonableness" from the perspective of the settling debtor(s). *In re W.T. Grant Co.,* 699 F.2d 599, 608 (2d Cir. 1983) (quotations omitted).

Against this backdrop, debtors have wide latitude to agree to a resolution of current and prospective intercompany claims that will pave the way for the creation of a unitary plan trust with a single-plan trustee who can administer each estate unfettered by potentially debilitating conflicts of interest. Structured properly, this settlement can also capture some of the administrative and economic efficiencies of a substantively consolidated postconfirmation estate, while at the same time respecting economic distinctions between the debtors' respective assets and liabilities. A model of one such settlement is set forth below.

The "Stipulated Asset Allocation" Model

One mechanism for resolution of inter-debtor conflicts within a plan is a so-called "stipulated asset allocation," which permits the plan trustee to divide the liquidation proceeds of any plan trust asset (irrespective of which debtor contributed it to the plan trust) between the respective estates in accordance with preset percentages set forth in the plan. The underlying premise of the stipulated-asset-allocation model is that so long as the debtors agree and stipulate in advance to (1) the residual value of the assets being contributed by each debtor to the plan trust on the effective date of the plan (*i.e.,* after paying or reserving for secured, administrative, and priority claims) and (2) the percentage share of postconfirmation administrative expenses that will be borne by each estate, it is possible for the estates to share in the proceeds of the liquidation of all plan trust assets while at the same time respecting entity separateness.

The resulting plan trust is analogous to a joint venture (JV) whereby each partner contributes assets of a certain value (fixed by an agreement of the partners) and agrees to be responsible for a fixed percentage of the JV's expenses, in exchange for a right to share in any proceeds of the JV's assets in an amount equal to the asset value contributed by such partner (net of that partner's share of JV expenses) as a percentage of all asset value contributed by all partners (net of all JV expenses). Legal distinctions between the partners are undisturbed by the JV relationship, and, assuming (1) the validity of the agreed-upon value assigned to the JV assets by the partners at the inception of their JV arrangement and (2) that the agreed-upon allocation of JV expenses fairly reflects the relative costs associated with preserving and liquidating the assets contributed by each partner, economic distinctions between assets contributed by one partner versus another partner are preserved by virtue of the agreed-upon allocation of proceeds of JV assets.

To illustrate, suppose four partners (P1, P2, P3 and P4) each contribute assets having a value of $100 to the JV and agree to bear JV expenses equally. Each partner would thereby be entitled to 25 percent ($100/$400) of the net proceeds of liquidation of any JV asset. Thus, both before and after joining the JV, each partner is in essentially the same economic position: Before joining, each partner had a right to 100 percent of the net proceeds of $100 worth of assets, and after joining, each partner has a right to 25 percent of the net proceeds of $400 worth of assets. To the extent there are economic efficiencies resulting from the collective administration of the partners' assets (*e.g.,* the ability to share overhead, economies of scale), then the partners are actually *better off* under the JV arrangement than they would be managing their property on their own. This is so because, as the costs of administering the assets decreases, the realizable value of those assets increases.

In addition to providing a cost-sharing mechanism that may result in added efficiencies, the JV structure provides the partners a vehicle for resolving claims among them on a non-cash basis. For example, suppose P1 is owed $10 from P2-P4, but they have no cash to pay their debts. In lieu of paying P1 $10, the three partners could each constructively settle its debt to P1 by allocating $10 of the asset value contributed to the JV to P1's capital account. In other words, P2-P4 would stipulate that, although they are each contributing $100 worth of assets to the JV, P1 will be treated—for all intents and purposes—as if it had contributed $130 (entitling it 32.5 percent ($130/400) of the net proceeds of the liquidation of any JV asset), and P2-P4 would each be treated as if they had contributed $90 (entitling them each to 22.5 percent ($90/$400) of net proceeds). Alternatively, P2-P4 could each agree to be allocated $10 of partnership expenses that would otherwise be borne by P1. In either scenario, all other things held equal, the partners are the same position economically as if P1 had received $10 from each of the other partners on the date the JV was formed.

3 *Protective Committee for Indep. Stockholders of TMT Trailer Ferry v. Anderson,* 390 U.S. 414, 424 (1968) (quoting *Case v. Los Angeles Lumber Products Co.,* 308 U.S. 106, 130 (1939)).

When entering into the JV arrangement, each partner has a real economic incentive to ensure that (1) the assets contributed by the other partners are not overvalued and (2) the allocation of partnership expenses between the partners fairly reflects the relative costs of maintaining and liquidating the assets contributed by each partner (*e.g.,* a partner contributing primarily illiquid assets is allocated more expenses than a partner contributing more liquid assets). Accordingly, while the partners' projections as to realizable asset value and costs of administration will necessarily entail some degree of speculation, the resulting distribution percentages should reflect a "fair and equitable" compromise based on the best information available to the partners at the time they enter the JV agreement.

In a liquidating chapter 11 context, the stipulated-asset-allocation model lends itself well to resolving inter-debtor claims and conflicts because, as previously noted, such disputes ultimately affect either the assets available for distribution from, or the aggregate liabilities of, a given estate. As a result, a negotiated resolution of such claims and conflicts could be effectuated via an adjustment to the asset value deemed contributed by each estate, or to that estate's share of allocable expenses.

To illustrate, suppose P1-P4 are affiliated chapter 11 debtors-in-possession using a centralized cash-management system whereby P1 pays expenses on behalf of all debtors. Assume further the debtors have intercompany claims and other disputes falling into the following categories: (1) booked intercompany balances; (2) claims for contribution or reimbursement (*e.g.,* by P1 to recover a portion of expenses paid on behalf of all debtors); (3) competing claims to ownership of assets; and (4) allocation of anticipated expenses of administering the plan. The resolution of each of these issues will ultimately affect the residual asset value that will be contributed by each debtor to the plan trust for the benefit of the debtor's creditors. One way to arrive at this residual value is outlined as follows:

Step 1: Determine the gross unencumbered asset value. Estimate the gross unencumbered asset value of each estate[4] using actual realized values for assets that have been liquidated, and estimated values for as-yet-unliquidated assets. The value of any shared assets held by one debtor or another should be allocated across the estates according to their respective shares. Any disputes as to the ownership of an asset can be resolved in this step by allocating the asset's value in some proportion between those estates laying claim to it.

Step 2: Layer in effect of prepetition intercompany balances. Adjust the asset values from Step 1 to reflect the hypothetical settlement of prepetition intercompany balances. For purposes of this calculation, receivables from each debtor (as modified to reflect imputed intercompany claims) are treated as assets of the various payee debtors (and corresponding liabilities of the payor-debtor), valued at an amount equal to the anticipated distribution to general unsecured creditors of the payor-debtor's estate.

Step 3: Assign "direct" case administrative costs. Adjust the asset values from Step 2 to reflect the costs of chapter 11 administration accruing prior to the effective date of the plan (both paid and anticipated) that are directly allocable to a particular estate. For example, professionals' fees relating to the sale of P3's assets that were actually paid by P1 would be allocated to P3 by decreasing its adjusted unencumbered asset value with a corresponding increase to P1's adjusted unencumbered asset value (as in the JV example above, where the partners pay their debts to P1 by adjustment to their respective capital accounts). Decrease each debtor's assets by the amount of any directly assignable professionals' fees and other administrative expenses that are estimated to accrue prior to the effective date of the plan.

Step 4: Allocate shared case administration costs. Adjust the asset values from Step 3 to reflect a "fair and equitable" allocation of the costs of chapter 11 administration (both paid and anticipated) that are not directly assignable to a particular estate (*e.g.,* professional fees for general services benefiting all debtors). Given that the primary focus of a liquidating chapter 11 case is to preserve and maximize asset value available for distribution to unsecured creditors, a principled basis for allocating costs between the debtors' estates would be *pro rata* in proportion to the adjusted unencumbered asset value provided by Step 3, with appropriate adjustments for any estates that either were more difficult to administer, or whose assets were comparatively more costly to maintain and/or liquidate prior to the plan effective date.

Step 5: Account for secured, administrative and priority exposure. Adjust the asset values from Step 4 to reflect each estate's estimated exposure to secured, administrative and priority claims that will be paid ahead of general unsecured creditors. The resulting adjusted asset value for each estate represents the residual value of assets to be contributed to the plan trust for the benefit of creditors (in the JV example above, this value represents the amount deemed contributed to the JV by each partner).

Step 6: Allocate costs of plan administration. Finally, adjust the asset values from Step 5 to reflect a "fair and equitable" allocation of estimated plan administration costs between the estates.[5] As with the allocation of pre-confirmation costs of administration in Step 4, one principled basis for allocating plan administration costs between the debtors' estates would be *pro rata* in proportion to the adjusted unencumbered asset value provided by Step 5, with appropriate adjustments for estates that either are more difficult to administer, or whose assets are comparatively more costly to maintain and/or liquidate. The resulting adjusted asset values represent the residual value of assets that will be available for distribution to creditors after payment of the expenses of the liquidating trust.

The asset value from Step 6 for each estate as a proportion of the total value for all estates makes up the stipulated asset allocation (*i.e.,* the percentage of proceeds of each asset contributed to the plan trust that will be distributed to the creditors of each estate). In the JV example above, this was 25 percent for each partner. In a real case with real numbers, where there are a number of variables in play and judgment calls to be made (*e.g.,* as to how to allocate shared administrative costs), the resulting allocation percentages will not be so tidy. Nonetheless, administration of the plan will be simplified greatly, because a single-liquidating trustee will be free to dispose of all plan trust assets without regard to which debtor entity contributed them, and to distribute the proceeds among the estates in accordance with a simple percentage set forth in the plan.

4 A determination will need to be made as to the effective date of the valuation (*e.g.,* petition date vs. plan effective date).

5 Note that, in the JV example, it was assumed that all partners would share JV expenses equally. Accordingly, adjustments to asset values were not necessary to determine each partner's share of net distributable assets from the JV.

Conclusion

This is a rough outline of how a comprehensive plan settlement of inter-debtor claims and disputes might be structured to streamline administration of a nonconsolidated liquidating plan. This outline leaves many stones unturned and many questions unanswered, and the model itself may not be practicable in a given case. Given the flexibility afforded by the liberal plan 9019 settlement standard, we believe that the model is highly customizable to fit the circumstances of many different cases and presents a viable alternative to substantive consolidation in a multi-debtor liquidating chapter 11. ■

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