Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT®

FEBRUARY/MARCH 2016

EDITOR'S NOTE: INSOLVENCY ABROAD
Steven A. Meyerowitz

THE ASEAN ECONOMIC COMMUNITY AND LEGAL CONVERGENCE OF CONTRACT ENFORCEMENT AND INSOLVENCY LAWS: AN OPPORTUNITY TO STIMULATE THE GROWTH OF GLOBAL SUPPLY CHAINS AND WORLD TRADE IN THE ASEAN REGION
Patrick E. Mears

THE BRAZILIAN INSOLVENCY REGIME: SOME MODEST SUGGESTIONS—PART I
Richard J. Cooper, Francisco L. Cestero, Jesse W. Mosier, and Daniel J. Soltman

IN RE REVEL: THIRD CIRCUIT CLARIFIES STANDARD FOR STAYS PENDING APPEAL
Jason Kornmehl

THIRD CIRCUIT FINDS ESCROWS FUNDED BY SECURED LENDERS ARE NOT ESTATE PROPERTY AND THEREFORE NOT SUBJECT TO PRIORITIES ESTABLISHED BY THE BANKRUPTCY CODE
Lindsay M. Weber

LSTA PUBLISHES DETAILED RESPONSE TO ABI COMMISSION'S PROPOSED BANKRUPTCY REFORMS
Michael Friedman, Craig M. Price, and Mark D. Rasmussen

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:
Kent K. B. Hanson, J.D. at 415-908-3207
Email: .... kent.hanson@lexisnexis.com
For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3000
Fax Number . . . . (518) 487-3584
Customer Service Web site . . . . http://www.lexisnexis.com/custserv/
For information on other Matthew Bender publications, please call

Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (518) 487-3000

Library of Congress Card Number: 80-68780
ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)
ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])
Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

This publication is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

LexisNexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. A.S. Pratt is a registered trademark of Reed Elsevier Properties SA, used under license.

Copyright © 2016 Reed Elsevier Properties SA, used under license by Matthew Bender & Company, Inc. All Rights Reserved.

No copyright is claimed by LexisNexis, Matthew Bender & Company, Inc., or Reed Elsevier Properties SA, in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material may be licensed for a fee from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (978) 750-8400.

An A.S. Pratt® Publication

Editorial Office
630 Central Ave., New Providence, NJ 07974 (908) 464-6800
www.lexisnexis.com

(2016-Pub.4789)

Editor-in-Chief, Editor & Board of Editors

EDITOR-IN-CHIEF
Steven A. Meyerowitz
President, Meyerowitz Communications Inc.

EDITOR
Victoria Prussen Spears
Senior Vice President, Meyerowitz Communications Inc.

BOARD OF EDITORS

Scott L. Baena
Bilzin Sumberg Baena Price & Axelrod LLP

Thomas W. Coffey
Tucker Ellis & West LLP

Robin E. Keller
Lovells

Leslie A. Berkoff
Moritt Hock & Hamroff LLP

Michael L. Cook
Schulte Roth & Zabel LLP

Matthew W. Levin
Alston & Bird LLP

Ted A. Berkowitz
Farrell Fritz, P.C.

Mark G. Douglas
Jones Day

Patrick E. Mears
Barnes & Thornburg LLP

Andrew P. Brozman
Clifford Chance US LLP

Timothy P. Duggan
Stark & Stark

Alec P. Ostrow
Stevens & Lee P.C.

Kevin H. Buraks
Portnoff Law Associates, Ltd.

Gregg M. Ficks
Coblentz, Patch, Duffy & Bass LLP

Deryck A. Palmer
Pillsbury Winthrop Shaw Pittman LLP

Peter S. Clark II
Reed Smith LLP

Mark J. Friedman
DLA Piper

N. Theodore Zink, Jr.
Chadbourne & Parke LLP

PRATT'S JOURNAL OF BANKRUPTCY LAW is published eight times a year by Matthew Bender & Company, Inc. Copyright 2016 Reed Elsevier Properties SA., used under license by Matthew Bender & Company, Inc. All rights reserved. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. For permission to photocopy or use material electronically from *Pratt's Journal of Bankruptcy Law*, please access www.copyright.com or contact the Copyright Clearance Center, Inc. (CCC), 222 Rosewood Drive, Danvers, MA 01923, 978-750-8400. CCC is a not-for-profit organization that provides licenses and registration for a variety of users. For subscription information and customer service, call 1-800-833-9844.

Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz,

Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, No. 18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 718.224.2258. Material for publication is welcomed—articles, decisions, or other items of interest to bankers, officers of financial institutions, and their attorneys. This publication is designed to be accurate and authoritative, but neither the publisher nor the authors are rendering legal, accounting, or other professional services in this publication. If legal or other expert advice is desired, retain the services of an appropriate professional. The articles and columns reflect only the present considerations and views of the authors and do not necessarily reflect those of the firms or organizations with which they are affiliated, any of the former or present clients of the authors or their firms or organizations, or the editors or publisher. POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 630 Central Avenue, New Providence, NJ 07974.

LSTA Publishes Detailed Response to ABI Commission's Proposed Bankruptcy Reforms

By Michael Friedman, Craig M. Price, and Mark D. Rasmussen*

This article summarizes a few of the most significant points offered up by the Loan Syndications and Trading Association against the Commission of the American Bankruptcy Institute to Study the Reform of Chapter 11 proposed reforms.

The Commission of the American Bankruptcy Institute to Study the Reform of Chapter 11 (the "Commission") recently published its report (the "ABI Report"), which contained over 200 distinct proposed amendments to the Bankruptcy Code. The Loan Syndications and Trading Association ("LSTA")[1] released its own response to the ABI Report, titled "The Trouble with Unneeded Bankruptcy Reform: The LSTA's Response to the ABI Chapter 11 Commission Report" (the "Response").[2] After a comprehensive review of the Commission's proposals, the LSTA believes that the ABI Report's overall approach to reforming the Bankruptcy Code is misguided and that, if the recommendations contained in the ABI Report were adopted, the changes would be overwhelmingly harmful to debtors, creditors and credit markets, increasing the cost of credit to both performing and distressed businesses alike. This article summarizes a few of the most significant points offered up by the LSTA against the Commission's proposed reforms.

THE LSTA ARGUES THAT THE ABI REPORT'S PROPOSALS WOULD OVERWHELMINGLY DAMAGE THE RIGHTS OF SECURED CREDITORS AND ARE WHOLLY UNNECESSARY

The ABI Report makes a number of recommendations that would weaken

* Michael Friedman is a partner in Chapman and Cutler LLP's Banking and Financial Services Department and Co-Practice Group Leader of the firm's Bankruptcy and Restructuring Group. Craig M. Price is a partner in the firm's Bankruptcy and Restructuring Group. Mark D. Rasmussen is a partner in the Bankruptcy and Restructuring and Litigation Groups. The authors may be reached at friedman@chapman.com, cprice@chapman.com, and mark.rasmussen@chapman.com, respectively.

[1] The LSTA is a leading trade organization representing banks, insurance companies, fund managers, and other institutional investors that originate, syndicate, and invest in secured corporate loans and that trade in the secondary market for performing, stressed, and distressed loans and claims.

[2] The Response was drafted by LSTA's counsel at WilmerHale and included input and comments from a working group which included lawyers from Chapman and Cutler LLP.

secured creditors' existing protections under the Bankruptcy Code. Among the most potentially damaging proposals are: (i) diluting secured creditors' ability to obtain adequate protection against the depreciation of their collateral during the Chapter 11 process by introducing and limiting such protections to the "foreclosure value" of such collateral; (ii) requiring senior secured creditors to distribute a redemption option premium to out-of-the-money junior creditors to achieve a "fairer" distribution of assets in violation of the absolute priority scheme; and (iii) imposing stringent limitations on the terms of debtor-in-possession ("DIP") financing and on sales of a debtor's assets under § 363 of the Bankruptcy Code.

The LSTA's Response examines what it sees as the numerous flaws in the Commission's overall approach to bankruptcy reform, and largely focuses on the lack of empirical evidence showing that reform is necessary, the potential costs of the Commission's proposals to the efficiency of the bankruptcy process and to the broader credit markets and the harm it believes could be created if the Commission's reforms are adopted. We agree with these assessments. Set forth below is a summary of the LSTA's arguments.

THE COMMISSION'S PREMISE FOR REFORM IS MISGUIDED

The Response begins by examining the Commission's underlying premises for reform—that the "balance" between the "rights of senior creditors" as against "the reorganization needs of the debtor and the interests of other stakeholders" is now askew, that increased secured creditor control has undermined the effectiveness of the Bankruptcy Code and reforms are necessary to make the bankruptcy process more "fair." The Commission's solution to these perceived problems is to reduce secured creditor control by placing more power in the hands of the debtor.[3] The Response points out, however, that the Commission offers no reliable empirical evidence to support its underlying need for reform. Rather, the Commission, by its own admission, relies only on "anecdote" and "perception," and the ABI Report fails to provide any reliable empirical evidence that, in the real world, debtors are making inefficient decisions that systematically favor secured creditors over other constituencies.[4]

To the contrary, the Response cites recent studies that have investigated precisely this concern and suggest that the increased use of secured credit—and the power that secured creditors potentially wield in bankruptcy—has not produced a greater number of inefficient sales or liquidations. On the contrary,

---

[3] Response at 18.

[4] *Id.* at 13.

these studies reveal that secured creditor control does not lead to value reducing liquidations of otherwise viable businesses.[5] Instead of secured creditor control damaging the bankruptcy process, such studies found that "the conventional picture of secured creditor control and [§]363 sales is misleading and overstated."[6] Rather than secured creditors forcing quick sales, the evidence cited in the Response suggests that in cases with a dominant secured party or a high percentage of secured debt, a § 363 sale was less likely, rather than more likely, to occur.[7] Moreover, the studies cited found that secured creditor control does not lead to lower unsecured creditor recoveries.[8]

Given the lack of supporting evidence contained in the ABI Report, studies examining the proposed reforms have found that "[i]n the absence of reliable data demonstrating that a problem actually exists, we should hesitate before trying to fix the 'problem.' "[9] The Response asserts that empirical evidence simply does not support the claims that secured creditors have too much control over the Chapter 11 process or that such perceived secured creditor control has damaged the Chapter 11 process. In the absence of such evidence, the Response argues that there is no justification for the drastic changes proposed in the ABI Report.

BECAUSE IT'S NOT BROKE—DON'T FIX IT

In the ABI Report, the Commission argues that in the past, cases were longer, resulting in fairer treatment of all the parties and a more likely chance of reorganization. Today, the Commission claims that secured creditors are too quick to force a § 363 sale that possibly destroys value. Contrary to these claims, the Response argues that reform is not necessary as Chapter 11 "as is" is incredibly successful and works with remarkable efficiency. While the average stay in Chapter 11 for public and large private companies has plummeted, the Response argues that the speed of these cases is not a negative, but rather, results in greater recoveries for all creditors. Cases are also quicker, the Response argues, because since the advent of the Bankruptcy Code, the various constituent parties of today are more sophisticated and markets have become

---

[5] *Id.*; *see e.g.*, Jay Lawrence Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. Ill. L. Rev. 831, 831 ("*Westbrook*").

[6] Prof. Westbrook also found that secured creditor control, although important, is "not as pervasive as many have assumed" and that the "data strongly suggest that the conventional view that 363 sales dominate Chapter 11 practice is simply wrong." *Westbrook*, *Id.* at 834, 843.

[7] Response at 21.

[8] *Id.*

[9] *Id.* at 13, *citing Westbrook* at 845.

more liquid, making it easier for parties to trade in and out of debt. Nonetheless, given these changes, the research cited by the Response confirms that all parties still retain significant bargaining power.[10]

The Response argues that while financial markets and Chapter 11 practice have indeed changed significantly, there is no reliable evidence that those changes have been harmful. Rather, over time the Chapter 11 process has become faster, more efficient, and in many ways better than it was in the past. As proof of this success, other nations have sought to model their own insolvency laws on Chapter 11. Specifically, the Response points out that Brazil, the Czech Republic, and China have each recently adopted bankruptcy laws modeled on Chapter 11, including effective protections for secured creditors non-bankruptcy rights.[11] All of these factors, the Response claims, point to the fact that major reforms are not necessary.

THE REFORMS WOULD MAKE THE BANKRUPTCY PROCESS MORE EXPENSIVE AND TIME CONSUMING, NEGATIVELY EFFECT CREDIT MARKETS AND FAIL TO MAKE THE BANKRUPTCY PROCESS MORE "FAIR"

The Response also challenges the Commission's assertion that its proposals are designed to reduce the cost of bankruptcy, arguing instead that such reforms would make many cases longer, more complicated and costlier. In particular, the Response points out that reforms such as the proposed 60-day moratorium on § 363 sales,[12] as well as the proposal requiring several different types of judicial valuations—each requiring costly document discovery, accounting, and outside expert analysis—would add substantial time and expense to the bankruptcy process. The proposed reforms would also complicate the process. For example, the "redemption option value" proposal would require bankruptcy courts to determine the value of a hypothetical option to purchase the firm, which entails ascertaining the expected volatility in the firm's value over the redemption period. At best, any such inquiry would be extremely difficult to ascertain.

The Response also points out that because the proposed reforms would reduce secured creditors' recoveries, they would inevitably make it harder and

---

[10] *Id.* at 63.

[11] *Id.* at 24–26.

[12] The 60-day moratorium is specifically designed to extend the length of bankruptcy in the hope that more companies will be reorganized and that secured creditors will be less able to force value-reducing sales. *Id.* at 27.

more expensive for all companies to access credit.[13] In making this argument, the Response cites to a report from Fitch which noted the Commission's changes will decrease lenders' recoveries, and that lenders charge more interest to borrowers expected to have a lower "recovery given default."[14] Similarly, witnesses testified before the Commission that the proposed reforms would increase the price of secured credit.[15] That secured credit would become more difficult and costly to obtain in such circumstances is not just a supposition. Rather, when the United Kingdom instituted a similar reform with The Enterprise Act of 2002, creating a carve-out, known as the "prescribed part" that diminished the value of floating charges in order to pay a portion of the claims of general unsecured creditors, credit became more expensive and more difficult to obtain.[16] Similarly, legislation in Sweden which reduced the rights of secured creditors by enabling floating charges to secure only 55 percent of the value of collateral was found to raise interest rates and reduce the availability of credit, and was ultimately abolished.[17]

Lastly, the LSTA points out that the Commission seeks to replace fundamental principles of bankruptcy law with its own view of "subjective fairness."[18] However, according to the LSTA, the Bankruptcy Code does not have a substantive vision of a "fair" distribution of value; rather, it allocates value in accordance with the parties' non-bankruptcy state law property rights, entitlements and priorities. The LSTA alleges that abandoning the core principles that have formed the backbone of Chapter 11—such as absolute priority and adequate protection—would contravene state law, be unfair to those that have come to rely on such laws and only serve to make the law uncertain when it should be clear and predictable.[19] We would agree. Altering those fundamental

---

[13] *Id.* at 28–30.

[14] *Id.* at 28 (citing FitchRatings, Fitch: Proposed Changes to Chapter 11 Could Pressure First Lien Recoveries if Adopted (Dec. 9, 2014), *available at* https://www.fitchratings.com/site/fitch-home/pressrelease?id=946215).

[15] Market participants testified before the Commission that reducing secured creditor recoveries would almost certainly increase the cost of leveraged loans by lowering expected recoveries, or making it more uncertain, making it harder to price loans, reducing loan sizes, resulting in more expensive credit, a reduction in lenders willing to provide such credit, thus decreasing in the flow of capital to non-investment-grade companies. *Id.* at 29.

[16] *Id.* at 30–31.

[17] *Id.* at 31 (citing Geraldo Cerqueiro, Steven Ongena & Kasper Roszbach et al., Sveriges Riksbank, Collateralization, Bank Loan Rates and Monitoring, J.FIN (forthcoming) manuscript at 8, *available at* http://ssrn.com/abstract=1908097).

[18] *Id.* at 31–34.

[19] The LSTA argues that the proposed reforms—which would jettison the absolute priority

bargains where it is not necessary to do so simply to serve the Commission's own notion of fairness in of itself violates bankruptcy's basic vision of fairness and equity.

In the end, the Response argues that undermining the basic principles underlying today's Bankruptcy Code—especially in order to solve a problem that has not been proven to exist—could open the door to unintended and adverse consequences to the credit markets. We concur.

---

rule, serve as a tax on secured credit and alter parties' non-bankruptcy priorities—are reminiscent of the debate that took place in the 1990s about the revisions to Article 9 of the Uniform Commercial Code. At that time, various commentators questioned whether secured creditors should be permitted to take a blanket lien on all of a borrower's assets under state law and instead advocated for a "carve-out" for unsecured creditors. *Id.* at 36. As the Response makes clear, that debate was ultimately resolved in favor of permitting borrowers to encumber substantially all their assets, resulting in an increased flow of secured credit to non-investment-grade borrowers. *Id.* at 36. Amending the Bankruptcy law to be "fair" by providing carve outs for unsecured or junior creditors would, the Response argues, cause confusion and unpredictability, upsetting the current coherent framework of state and federal law.