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Client Alert

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May 12, 2015

It's Not All Bad: ABI Proposals That Could Benefit Secured Creditors

Fifth in a Series of In-Depth Discussions of Key Issues on the ABI Commission Final Report on Chapter 11 Reform

This is the fifth installment of Chapman and Cutler LLP's discussion of the proposals contained in the Final Report and Recommendations (the "Report") of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 (the "Commission").

In our previous four installments, we pointed out that many of the proposals contained in the Report will have significant and mostly negative implications for secured creditors. Among the most disconcerting proposals for secured creditors we discussed were: (i) the requirement, in certain instances, to pay a Redemption Option Value to junior creditors upon an asset sale or plan of reorganization in situations where senior lenders were not being paid in full; (ii) a 60-day moratorium on asset sales following a bankruptcy filing in the majority of instances; and (iii) the use of "foreclosure value" in determining whether a secured creditor is entitled to adequate protection. In addition, the Report's proposals would also codify recent case law allowing junior and unsecured creditors to limit secured creditor's prepetition liens on postpetition collateral.

While these specific proposals, along with others included in the Report, pose a significant threat to secured creditors, other proposals included in the Report could, in fact, greatly benefit secured creditors. In this client alert, we seek to explore some of these proposals, including:

- *Continuing to allow distributions to be based upon collateral's "going-concern" value;*
- *Requiring notes issued to secured creditors in cramdowns bear a market rate of interest;*
- *Allowing for credit bidding under current standards and without restriction, and rejecting recent rulings finding the chilling effect of credit bids to be a "cause" to limit bids;*
- *Allowing claims trading to continue without further restrictions; and*
- *Clarifying when a creditor's vote may be designated.*

"Going-Concern" Value Maintained As Basis for Plan Distributions

One of the core concerns that runs throughout the Report is the Commission's perception that secured creditors hold too much power over debtor's reorganizations. Given this concern, the Commission sought out methods to lessen the power of secured creditors and to unlock value to: (i) fund debtor's reorganizations and (ii) distribute to the debtor's other stakeholders. As we have discussed in detail in our earlier client alerts, two ways in which the Report proposes to wrest value from secured creditors is through: (i) the use of "foreclosure value" early in cases when determining adequate protection and (ii) requiring senior holders of so-called "fulcrum securities" to pay a Redemption Option Value in certain situations to junior creditors.

The Commission also considered whether to alter the valuation methodology used in the plan distribution context as well. Under current law, a secured creditor's plan distributions in a chapter 11 case are typically based upon a "going-concern" valuation of its prepetition collateral, rather than upon the collateral's liquidation, or foreclosure, value under state law. Further, the absolute priority scheme underpinning the Bankruptcy Code provides that junior creditors may only receive a distribution after senior creditors have been paid in full —

meaning no distributions may be made to junior creditors until senior creditors obtain the full value of their collateral. Given that a going-concern value almost always exceeds liquidation value, any change to this provision — i.e. valuing collateral at its liquidation value — could have significantly undercut the amount of a secured creditor's distribution, and been a significant method to redistribute value from senior to junior creditors.

While the Commission debated changing the method used to value secured creditors' claims for distribution purposes, in the end, the Commission concluded that secured creditors should receive distributions based upon the underlying prepetition collateral's going-concern, or "reorganization" value. Instead of changing the chapter 11 valuation methodology underlying the distribution system, the Commission believed that change was required only in certain discreet circumstances. As a result, while a number of the proposals serve to redistribute value attributable to senior claims to junior stakeholders (i.e. in the context of asset sale and adequate protection), if the proposals are approved by Congress, secured creditors would continue to receive distributions based on the going-concern value of their collateral as they do today.

Secured Creditors Entitled to Market Rate of Interest in Cramdowns

The Report also proposes overturning the recent *MPM Silicones* decision with respect to the appropriate "discount" or present value rate to be applied to replacement notes issued to secured lenders in connection with a cramdown chapter 11 plan.[1] Rather than following the "prime plus" formula established by the *MPM Silicones'* decision, the Report proposes utilizing a more market-based approach to interest rates in such instances.

In *MPM Silicones*, Judge Robert Drain of the U.S. Bankruptcy Court for the Southern District of New York interpreted the cramdown provisions of the Bankruptcy Code by using case law thought previously only to apply to chapter 13 consumer bankruptcy cases, and confirmed the debtors' chapter 11 plan that provided for the exchange of high-yield secured notes for long-term replacement debt bearing below-market rates. In reaching his decision, Judge Drain held that the cramdown provisions were satisfied where a debtor simply offers replacement notes bearing an interest rate composed of the sum of: (i) the U.S. Treasury rate for debt of similar duration, plus (ii) a risk premium reflecting the repayment risk associated with the debtor, which Judge Drain noted would "normally [be] in the range of between one to three percent, if at all."[2] The confirmed plan ultimately provided the senior noteholders with a 4.1% coupon on seven-year notes and a 4.85% coupon on seven-and-a-half year notes. Such rates are well-below the rates being paid in the market for similar secured debt.

Believing that the method adopted in *MPM Silicones* likely under-compensates creditors, the Commission recommended that *MPM Silicones'* "prime plus" formula be dropped for a more flexible, market-based approach. Such a formula would utilize an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as the debtor's industry, projections, leverage, revised capital structure and obligations under the plan. The Commission believes that using this formula will result in higher interest rates for creditors that more accurately reflect the economic realities of the case. Adoption of this proposal is especially important given the fact that the Bankruptcy Court's ruling was recently affirmed by the District Court for the Southern District of New York,[3] making the holding in *MPM Silicones* applicable to all cases filed in this critical district.

Credit Bidding Allowed Without Restrictions

The Commission has further recommended in its Report, despite recent rulings by certain bankruptcy courts, that credit bidding be allowed without restriction. Section 363(k) of the Bankruptcy Code allows a secured creditor to credit bid the full amount of its allowed claim unless the court orders otherwise for "cause." Secured creditors' right to credit bid has been under fire in a number of recent bankruptcy court decisions in which creditors have argued, and courts have allowed for, a greatly expanded definition of what constitutes "cause." For example, in one case, a secured creditor's right to credit bid was limited on account of a loan purchaser's "overly zealous loan to strategy," which the court found discouraged competitive bidding.[4] Similarly, a secured creditor's bid was limited for "cause" where the amount of the underlying claim was disputed and the court found that allowing the creditor to bid the full amount of its claim would freeze-out other competitive bids.[5] Since parties can always allege that a credit bid "chills" other third parties' bids, these cases present a serious impediment to the unfettered right of all secured creditors to credit bid the full face amount of their claims.

Upon reviewing these cases, however, the Commission recommended maintaining the current standard under § 363(k). Importantly, the Commission also recommended eliminating the "chilling effect of credit bidding" as a basis for "cause" to limit a credit bid. Instead, the Commission proposed that courts attempt to mitigate any chilling effects of credit bidding through its control of the auction and sale procedures approved in the case rather than through any limits or prohibitions on credit bidding. Adoption of such reforms could remove any cloud over a secured creditors' right to credit bid the full face amount of its claims.

Claims Trading Not Restricted

Claims trading provides much needed liquidity to the market, allowing parties who would rather not participate in a reorganization process a way to exit the case, while allowing other parties a way to invest in opportunities that may arise in a restructuring context. Although claims trading provides an important option for creditors to liquidate their claims on the secondary market, others have criticized claims trading for among other things: (i) destabilizing a debtor's reorganization efforts, (ii) removing creditors with a vested interest in the debtor's business from the reorganization process, and (iii) providing arbitrage and takeover opportunities that may depress value and harm other creditors.

To increase transparency and disclosure, Bankruptcy Rule 2019 was amended in 2011 to increase the information required of certain key parties acting collectively in bankruptcy cases. After weighing the various pros and cons of claims trading, given the increased disclosure requirements, the Commission determined not to propose any changes to current claims trading practices.

The Commission did, however, recommend that contractual assignments and/or waivers of voting rights in favor of senior creditors under an intercreditor, subordination, or similar agreement be deemed unenforceable, and that subordinated creditors retain the right to vote on a plan and to invoke the protections of Bankruptcy Code § 1129(b). Under this change, the contractual assignment of voting rights in favor of an assignee or purchaser of a claim against the estate would only be enforceable to the extent that a portion of the claim and economic interest is also transferred to the assignee or purchaser.

An "Ulterior Motive" Alone Is Insufficient To Designate A Creditor's Vote

Additionally, the Commission examined when a court may disqualify a creditor from voting to find that a perceived bad motive is insufficient. Section 1126(e) of the Bankruptcy Code allows a court to "designate" or disqualify a creditor's plan vote if such vote was not given in "good faith." Parties have sought to strip creditors of their right to vote on a plan when the creditor has been alleged to have an "ulterior motive," behind its vote, such as using their vote in an attempt to assume control of the debtor, holding interests in debtor's competitors, having a business agenda that conflicts with the debtor's reorganization or having nominal economic exposure compared to other creditors because of a hedging strategy.

The threat to disqualify votes based on these factors has often been a powerful weapon, particularly against private equity investors, who may inadvertently fall within one of these categories but lack any bad faith or nefarious purposes underlying a particular plan vote.

After reviewing this issue, the Commission agreed that holding interests potentially in conflict with the interests of the debtor or other creditors in the voting class should not automatically disqualify a creditor's vote on a chapter 11 plan. Likewise, considering these interests and voting in the creditor's self-interest should not necessarily alone warrant designation. The Commissioners acknowledged, however, that at some point, self-interested conduct by a creditor holding interests adverse to the debtor or other creditors in the class should result in the creditor losing its voting rights in the case.

As a result, the Commission proposed that Bankruptcy Code § 1126(e) be amended to permit courts to consider both whether the creditor's vote was "manifestly adverse" to the interests of the general creditors in the class or was cast in bad faith. The Commission believes that this hybrid standard would best preserve creditor autonomy and protect investors holding varying interests while, at the same time, providing courts with the ability to protect the estate and creditors from those having impermissible conflicts of interest.

Changes to the Sale Process

Finally, the Commission has sought to re-affirm that assets sold as part of a plan process are entitled to the same protections as if sold in a § 363 sale. Section 363(f) of the Bankruptcy Code permits a debtor may sell its property in a § 363 sale "free and clear" of any interest, if certain conditions are met and the sale is approved by the court.[6] In certain interests, assets are also sold in connection with a plan of reorganization. Some courts have questioned whether assets sold under a plan of reorganization are entitled to the broad § 363(f) release. After considering this issue, the Commission has recommended that a debtor's assets receive the same treatment whether sold pursuant to § 363 or a plan of reorganization.

Conclusion

Overall, while the proposals set forth in the Report contain substantial negative implications for the rights secured creditors, a number of the proposals may enhance the rights of secured creditors. As we have pointed out in our previous alerts, the proposals face a long path before becoming law. Nonetheless, it should be acknowledged that the ABI is an important voice that has substantial influence before Congress. Further, even prior to enactment of any amendments to the Bankruptcy Code, it is likely that certain parties will seek to utilize many of the policies and recommendations contained in the Report in order to influence courts, so it is vital that all parties understand the various proposals set forth therein.

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1 *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

2 Transcript of Hearing, *In re MPM Silicones, LLC, et al.*, Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014) at 68:10-12; 77:2-3.

3 *See Memorandum Decision*, *In re MPM Silicones, LLC*, Case No. 14 CV 7471 (S.D.N.Y. May 4, 2015).

4 *In re Free Lance-Star Publ'g Co. of Fredericksburg, Va.*, 512 B.R. 798 (Bankr. E.D. Va. 20141), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

5 *In re Fisker Automotive Holdings, Inc.*, Case No. 13-13087 (KG) (Bankr. D. Del. Jan. 17, 2014) [Docket No. 483].

6 The Report also reaffirms the ability of a debtor to sell property "free and clear" of most interests and seeks to clarify the definition of "interest" by adopting a broad definition of the term to include most claims (to the extent permitted by law), including generally successor liability claims. Clarifying the liabilities remaining with the estate from those being transferred should help to facilitate sales.

For More Information

If you would like further information concerning any of the matters discussed in this alert, please contact any of the following attorneys, or contact any other Chapman and Cutler attorney with whom you regularly work:

David T.B. Audley, Partner
312.845.2971
audley@chapman.com

Michael T. Benz, Partner
312.845.2969
benz@chapman.com

Todd J. Dressel, Partner
415.278.9088
dressel@chapman.com

Michael Friedman, Partner
212.655.2508
friedman@chapman.com

Larry G. Halperin, Partner
212.655.2517
halperin@chapman.com

James Heiser, Partner
312.845.3877
heiser@chapman.com

Joon P. Hong, Partner
212.655.2537
joonhong@chapman.com

Craig M. Price, Partner
212.655.2522
cprice@chapman.com

Mark D. Rasmussen, Partner
312.845.3276
mark.rasmussen@chapman.com

Stephen R. Tetro, II, Partner
312.845.3859
stetro@chapman.com

Franklin H. Top, III, Partner
312.845.3824
top@chapman.com