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Client Alert

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Twin Daggers: Proposed 363(x) Amendments and Revisions to Adequate Protection Provisions Would Significantly Erode Secured Creditors' Recoveries

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

As discussed in our first two installments, the American Bankruptcy Institute ("ABI") released its Final Report and Recommendations (the "Report") containing proposals to modify the Bankruptcy Code, many of which will have significant and negative implications for secured creditors. This article discusses two of the Report's additional proposed changes that, if approved, would greatly alter secured creditors' rights during the initial period after the commencement of a bankruptcy case. The Report recommends amendments to § 363 (which they dub "363(x)") that seek to lengthen the § 363 sale process. The Report also proposes changes to the rules regarding "adequate protection," the Bankruptcy Code's protection afforded secured creditors as compensation for the erosion of value of their collateral caused by: (a) the inability of secured creditors to exercise their foreclosure rights on their collateral and/or (b) a debtor in possession loan ("DIP Loan") with senior or "priming" liens on the secured creditors' collateral. Taken together, these proposals would likely lengthen the duration of bankruptcy cases, significantly erode the value of secured creditors' liens on collateral and result in lower recoveries for secured creditors, all of which should be very troubling for secured creditors.

Changes to the Existing 363 Sale Procedures – the "363(x) Amendments"

The Bankruptcy Code currently allows for a quick and efficient sale of all or substantially all of a debtor's assets after a bankruptcy filing (a *"363 Sale"*) to the extent that the court finds such sale to be in the best interests of a debtor's estate. Despite this fact, the Report contends that 363 Sales are occurring too quickly, often only for the benefit of secured creditors, and deny debtors and junior creditors sufficient time to examine other restructuring alternatives. Without citing any empirical evidence upon which to base such claims (and despite strong evidence that 363 Sales are just as efficient as reorganizations and do not lead to lower creditor recoveries[1]), the Report recommends that § 363 of the Bankruptcy Code be amended to, among other things, implement a 60-day moratorium on all asset sales following a bankruptcy filing, except in limited instances where a debtor could prove "extraordinary circumstances" through clear and convincing evidence. While such amendments may initially appear innocuous, upon closer examination, the proposed amendments are likely to: (i) shift leverage to junior creditors, (ii) significantly increase the costs to secured creditors of effecting remedies through a 363 Sale and (iii) perhaps most importantly, necessitate additional financing in order to allow the debtor to operate during the moratorium period. Given the lack of evidence necessitating a need for a moratorium, requiring additional time prior to a 363 Sale will likely only serve to harm secured creditors while providing little to no benefit to junior creditors.

Reforms to the Adequate Protection Provisions

Mandating additional time for 363 Sales will, by definition, require additional financing to allow the business to operate for such additional period of time. Because collateral value is tight in many bankruptcies in which secured creditors are effecting remedies through a sale of assets, the protections afforded secured creditors under the Bankruptcy Code to preserve the secured creditor's collateral value are all the more critical. However, here too, the Report recommends profound changes with the hope of expanding debtors' access to DIP Loans. While such changes may increase a debtor's ability to obtain post-bankruptcy financing over the objection of the secured creditor, they would, at the same time, also likely significantly erode secured creditors' collateral value.

Adequate Protection Under Existing Law

Adequate protection is designed to insulate a secured creditor from a decline in the value of its collateral

(including its cash collateral) during the pendency of a bankruptcy case or as a result of a “priming” DIP Loan by requiring secured creditors to receive compensation for any diminution in value. Thus, a lender seeking to provide a DIP Loan to a debtor cannot prime (or subordinate) an existing secured creditor without the debtor first providing adequate protection to such existing secured creditor. Debtors or junior creditors often try to demonstrate that a secured creditor is adequately protected by arguing that there exists an “equity cushion” *i.e.*, the value of the secured creditor’s collateral exceeds the outstanding amount of secured debt plus any proposed DIP Loan of equal or senior rank.

Under existing law, whether a secured creditor is adequately protected by the existence of an “equity cushion” is determined by comparing the underlying value of the creditor’s collateral to the outstanding amount of its secured claims. When determining adequate protection in connection with the debtor’s use of cash collateral or obtaining a priming DIP Loan for an operating business, courts value the assets comprising the secured creditor’s collateral based upon their value as a going concern. With some exceptions, courts generally have not permitted a debtor to utilize cash collateral or enter into a priming DIP facility over the objection of the secured creditor unless the secured creditor’s “equity cushion” is in the approximate range of 20% or more.[2] This adequate protection is designed to ensure that: (i) the new DIP Loan is not secured by collateral that is appropriately allocated to the existing secured creditor and (ii) the continued operation of the debtor, use of cash collateral or incurrence of any new DIP financing will not result in erosion of the secured creditor’s collateral position.

Diminishing the Value of Collateral Through Use of “Foreclosure Value”

To further the Report’s express goal of providing debtors with greater options to obtain DIP Loans, the Report proposes that, solely for the purposes of determining adequate protection and calculating the secured creditor’s equity cushion, a secured creditor’s collateral should be valued based upon the entirely new concept of “Foreclosure Value.” The Report defines Foreclosure Value as the “net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor’s collateral under applicable non-bankruptcy law.”[3] The Report states that this measure will “capture the value of the secured creditor’s interest” on the bankruptcy filing date and peg collateral value at “the value a secured creditor’s state law foreclosure efforts would produce if the automatic stay were lifted or the bankruptcy case had not been filed.”[4] Foreclosure Value would be “determined case by case based on the evidence presented at the adequate protection hearing, taking into account the realities of the applicable foreclosure market and legal schemes.”[5]

The Report further proposes an additional new method of calculating a secured creditor’s equity cushion called “Value Differential.” Under this proposal, an equity cushion, and hence adequate protection, can be established, in whole or in part, by showing: (i) the net cash value that a secured creditor would realize upon a hypothetical sale of the secured creditor’s collateral under § 363 exceeds (ii) the collateral’s Foreclosure Value.

Without any legal or factual support, the proposal is premised on the notion that the use of “Foreclosure Value” will result in a lower valuation of the collateral than the value achievable in a 363 Sale, thereby enhancing the debtor’s ability to obtain DIP financing. However, it is far from clear that this premise is correct. Secured creditors often effect remedies through foreclosure sales under the Uniform Commercial Code enlisting the assistance of an investment banker and establishing a robust auction process. Such sale values could very well capture going concern value and equal or exceed the value a sale could achieve under a 363 Sale.[6] However, to the extent the use of “Foreclosure Value” does in fact result in an arguably artificial lower valuation as designed, there is little doubt that this would have the effect of reducing secured creditors’ recoveries in the bankruptcy case.

The Proposed Reforms Would Erode Secured Creditors’ Recoveries

Secured Creditors May Be Forced to Finance the Bankruptcy Case with Their Collateral

Longer bankruptcy cases often generate greater costs without necessarily delivering any greater return to creditors. Using “Foreclosure Value” rather than going concern value will likely allow debtors to obtain a priming DIP Loan at the outset of the bankruptcy case where they otherwise may not be able to do so without the consent of the secured creditor. For instance, consider a debtor that has $100 million of senior secured debt, its assets have a going concern value of $80 million but a bankruptcy court determines that the “Foreclosure Value” of the secured creditor’s collateral is only $50 million. Under existing law, the debtor would have no ability to obtain a DIP Loan over the secured creditor’s objection because the value of the collateral is less than the secured claim ($80 million *minus* $100 million) and there is no “equity cushion” to provide the secured creditor with adequate protection. However, under the Report’s proposal, because the going concern value exceeds the “Foreclosure Value” by $30 million ($80 million *minus* $50 million), there exists an “equity cushion” that could support a priming DIP Loan of $20 million and still leave the secured creditor with an “equity cushion” equal to $10 million or 20% of the Foreclosure Value.

Such priming DIP Loan would be senior to the secured creditor's debt and, to the extent that there is no value accretion through the implementation of a plan or an eventual sale, the prepetition secured creditor would have shouldered the burden of the additional costs of the case through a reduced recovery. Thus, in the example described above, unless the debtor is able to generate an additional $20 million in value through increased efficiencies or its operations in bankruptcy, the secured creditor's collateral position will have been eroded as will the secured creditor's ultimate recovery. Clearly, the secured creditor will not have received "adequate protection" on account of the debtor's entering into the priming DIP Loan.

Increased Litigation

The Report offers no guidance on the methodology one should follow in calculating the contemplated "hypothetical" valuations required to determine Foreclosure Value and the Value Differential. The Report is severely lacking in substance on how these new valuation dichotomies would actually and credibly play out in practice. Thus, it is easy to imagine the costly litigation quagmire, centering on a battle of the valuation experts, in which bankruptcy cases could descend at their very outset. Such litigation would consume vast estate and secured creditor resources, causing further erosion of potential recoveries. Moreover, such litigation could chill the efficient redeployment of operating assets and likely place jobs and businesses at a higher risk of permanent elimination by a true liquidation.

Limited Historical Data Could Result in Distortions of Value

Equally troubling is the lack of any current known data set to which an expert could readily refer to determine or compare foreclosure "net values" for a business' assets or other unique collateral items. It seems unrealistic that an expert could credibly opine on the "hypothetical" Foreclosure Value when, historically, secured creditors rarely opt to pursue state law foreclosure remedies and instead choose to support and finance chapter 11 filings and the pursuit of 363 Sales or reorganization plans where feasible. Secured creditors, therefore, are at serious risk of having their collateral subject to a valuation that may be so hypothetical that it bears no semblance to reality.

Loss of Creditor Control

By materially loosening the adequate protection standards and encouraging debtors to obtain post-petition priming loans that may erode secured creditors' collateral (all without requiring an exit strategy), the proposed reforms would significantly reduce the power of prepetition secured creditors. Faced with a potential priming DIP Loan and potential erosion of collateral and recoveries, secured creditors could face diminished negotiating leverage with debtors and unsecured creditors committees at the outset of a case to reach a consensual deal regarding a workable DIP facility and sale process. Moreover, these amendments may force existing secured creditors to agree to match or offer less favorable terms than a proposed priming DIP Loan if the existing secured creditor wants to remain in the "driver's seat" with respect to its collateral. In such event, the existing creditor could be dragged into a long and costly non-consensual plan process that it otherwise would not have chosen to finance under current law by having to match or better the terms of a competing DIP Loan.

Junior Creditors Would Have a Free Option to Provide a DIP Loan with Non-Economic Terms

Finally, perhaps one of the most ominous repercussions of the proposal is that, because the erosion of any collateral value in a bankruptcy proceeding will often be borne by exclusively by the secured creditors rather than the priming DIP Loan provider, junior out-of-the-money creditors may be incentivized to provide non-economic (perhaps even interest-free) DIP Loans to debtors that would permit debtors to operate with few restrictions for an extended period in the "hope" that such extended time would result in an increase in value of the debtors' assets beyond the secured creditors' total claims. Since such DIP Loan would have a priming lien and hence be senior to the prepetition secured debt, unless the value of the debtor's assets fall below the amount of the DIP Loan, the DIP Loan would still be repaid in full while the secured creditors would suffer devastating losses. The proposal would therefore provide junior out-of-the-money creditors a free option to gamble on a high-risk strategy using the secured creditors' collateral and recoveries with virtually no risk to their investment.

Conclusion

The proposed changes to lengthen the 363 Sale process and allow debtors to finance their cases using the secured creditors' collateral without any meaningful protection is a radical departure from existing precedent and current economic expectancies of secured creditors. It advances a paradigm shift in the treatment of secured creditors in bankruptcy and their established rights. The proposal would rebalance power and control among secured creditors, debtors and unsecured creditors in favor of the debtor and unsecured creditors. Overall, these proposals would likely have an adverse impact on the availability and cost of secured credit.

As we have discussed in our prior client alerts, these proposals are not the law at this time. However, if enacted, secured creditors would have to significantly reassess their recovery expectations in the event of default.

Therefore, secured creditors and their advisors are advised to maintain a vigilant eye on the efforts to implement these proposed reforms and their progress.

1 Gilson, Stuart C., Hotchkiss, Edith S. and Osborn, Matthew G, *Cashing Out: The Rise of M&A in Bankruptcy* (January 8, 2015). Available at SSRN: http://ssrn.com/abstract=2547168 or http://dx.doi.org/10.2139/ssrn.2547168

2 See, e.g., *In re James River Associates*, 148 B.R. 790, 796 (E.D. Va. 1992) (holding that if a debtor has equity in a property sufficient to shield the creditor from the declining value of the collateral then the creditor is adequately protected).

3 *Report* at 67.

4 *Id.* at 71.

5 *Id.*

6 In fact, Gilson, Hotchkiss and Osborn, *supra*, note 1, have specifically found that value from chapter 11 reorganizations are not necessarily superior to that received from a going-concern sale.

For More Information

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