The ABI Commission on Reform of Chapter 11 Final Report

What Secured Creditors Need to Understand

June 2015

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Introduction

On December 8, 2014, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the *"Commission"*) released its Final Report and Recommendations (the *"Report"*) for amendment to the current Bankruptcy Code. The proposals contained therein are significant, and on the whole, largely harmful to the rights of secured creditors. As we have indicated in our prior client alerts published in 2014, the Report is only the latest salvo in the continuous onslaught against secured creditors' rights that has been evident for the last several years.

As of now, the proposals face a long path before becoming law and even the ABI does not believe that any legislation would be enacted prior to 2018. Nonetheless, the ABI is an important voice and the ABI began lobbying Congress in early 2015. More importantly, even prior to enactment of any amendments, 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. As we have seen over the recent past, some judges may be moved by such arguments.

It is therefore critical for all secured creditors to understand the proposed amendments and their impact on secured credit. As such, this compendium of client alerts contains an in-depth analysis of certain key provisions that are likely to significantly affect the rights of secured creditors. Among the topics to be discussed will be:

Redemption Option Value and Asset Sales – Among the most troubling of the proposals is what the Report deems the "Redemption Option Value." This proposal would alter the current distribution scheme contained in the Bankruptcy Code, centered around the absolute priority rule, and require senior creditors to "gift" a portion of the debtor's enterprise value to the next junior class of creditors in connection with a sale of assets or plan of reorganization. This proposal would likely result in increased litigation over the appropriate valuation of the redemption option value payable to the junior class and increase the cost of funding chapter 11 bankruptcy cases for all borrowers. The Report also proposes requiring a 60-day moratorium on most asset sales following a bankruptcy filing and instituting a higher standard to approve assets sales. Rather than serving as helpful reform, this proposal appears designed to create additional inter-creditor conflict, and only likely to make cases longer and more expensive by forcing secured creditors to finance cases for a longer period.

Adequate Protection and DIP Loans – Similarly troublesome for secured creditors is a proposal which would compel courts to use "foreclosure value" of the collateral rather than going concern value in determining whether adequate protection is due and owing to secured creditors at the outset of a bankruptcy case. Using foreclosure value will significantly reduce secured creditors' protections against the use of their collateral by debtors to finance a bankruptcy proceeding without the secured creditors' consent. The Report also proposes to prohibit DIP loans from containing milestones or benchmarks requiring the debtor to take certain actions in a bankruptcy (such as filing a plan or commencing a sale process) or from containing representations regarding the validity of liens within 60 days of the filing of a petition. DIP loans would be prohibited from containing "rollups" of pre-petition debt into DIP loans by pre-petition lenders unless the lender extends substantial new credit on terms better than any alternative party and the court finds the rollup is in the best interests of the estate. The Report also suggests that intercreditor agreement provisions restricting the ability of junior creditors to provide DIP financing be made unenforceable. Such alterations to the current landscape would likely materially disadvantage secured creditors by both: (i) taking away much of their protection against depreciation in the value of their collateral during the bankruptcy case, and (ii) limiting their ability to quickly and efficiently secure a path to exiting bankruptcy.

Section 552 and the "Equities of the Case" Exception – In an important recent decision,[1] junior creditors were successful in using the "equities of the case" exception of § 552(b) to cut off lenders' pre-petition liens on any increased value generated post-petition by arguing that the debtor's post-petition use of unencumbered property, including "time, effort, and expense by the Debtors' estates," had enhanced the value of the prepetition collateral. The effect was to reduce the overall value allocated to the prepetition liens in connection with the post-petition proceeds from an asset sale. Despite this case, § 552 has been of limited effect as debtors typically waive their rights under this provision as part of an adequate protection or DIP package given to the prepetition lenders. In a blow to secured creditors, the Report now recommends that such waivers be prohibited,[2] and that the evidentiary standard required to demonstrate post-petition enhancement of prepetition collateral be lowered. If enacted, the proposal would likely lead to increased litigation over the scope of pre-petition liens and post-petition enhancements as well as higher capital costs associated with uncertainty of the value of lenders' post-petition liens.

Eliminating the Accepting Impaired Class Requirement – Section 1129(a)(10) currently protects secured creditors by making it more difficult to approve cramdowns, *i.e.*, a plan of reorganization over the objection of the secured lender, without the consent of at least one "accepting impaired class." The Report proposes eliminating this requirement, thereby making it easier for debtors to cramdown plans over the objection of secured creditors that have unsecured "deficiency claims."

While most of the recommendations largely seek to increase the rights of junior creditors at the expense of senior creditors, there are, fortunately a few bright spots. Among these are: (i) secured creditors should receive the "going concern" value of their collateral rather than its liquidation value upon a sale or plan of reorganization; (ii) courts should not apply the "prime plus" formula adopted by the Supreme Court in *Till* and applied in the chapter 11 context in the recent *MPM Silicones* decision (whereby it was used to substantially reduce the senior secured creditors' recoveries), recommending instead that secured creditors be entitled to a market rate of interest on replacement notes in a cramdown context; and (iii) secured creditors be entitled to credit bid the full amount of their claim regardless of the effect such bids have on other bidders (contrary to the holding in *Fisker*). Importantly, the Report also does not place any significant restrictions on claims trading.

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1 *In re Residential Capital, LLC*, 501 B.,R. 549 (Bankr. S.D.N.Y. 2013)

2 The Report similarly recommends that debtors should not be permitted to waive their rights under § 506(c), which provides debtors with the ability to recover from secured creditors' collateral the necessary costs and expenses of preserving or disposing of that collateral.

Redemption Option Value: Broad Implications for Secured Lenders

One of the most far reaching of the proposals contained in the Report is to require, in connection with a sale of all or substantially all of the debtor's assets (a *"363 Sale"*) or a plan of reorganization, that senior creditors provide certain out-of-the-money junior creditors or equity holders with what the Report terms the "Redemption Option Value." As will be more fully discussed, this value is intended to capture (and transfer to certain junior creditors) the value of a hypothetical option to purchase the entire company and satisfy all of the debtor's senior debt, thereby allowing certain out-of-the-money junior creditors to share in the possibility of future value appreciation of the debtor's assets within a defined time period following consummation of the 363 Sale or confirmation of the plan of reorganization.

For many reasons, this proposal should be troubling to secured lenders. First and most importantly, the proposal represents a significant deviation from the absolute priority rule that has served as a bedrock principle of the Bankruptcy Code and upon which lenders have come to rely when offering and pricing credit. In contravention of the absolute priority rule, in order to exit bankruptcy, the proposal would require an economic transfer of value from impaired senior creditors to out-of-the-money junior creditors or equity holders. Moreover, although the Report contends that the proposal will streamline cases and decrease litigation, it is more likely to have the opposite effect. Given the complexity of the proposal and the numerous factors that will need to be determined in order to calculate the hypothetical value of the debtor's business over a future time period and the corresponding value of the redemption option, there is a strong likelihood that such a proposal would only lead to increased litigation, leading to longer and more expensive bankruptcy proceedings.

The Report also ignores the potentially significant impact such a proposal may have on the broader credit markets. The absolute priority rule and access to an efficient sale process to effect secured creditor remedies have been fundamental factors in establishing the availability and pricing of credit. If this proposal were to be adopted, there very well may be unintended and largely negative consequences to the availability and pricing of credit.

Finally, despite the very real dangers of added complexity and cost to bankruptcy proceedings and the disruption to the credit markets, the Report does not provide any real empirical data justifying the need for these drastic changes. The Report contends (without data) that junior creditors have been hurt by quick 363 Sales and plans of reorganization implemented during a trough in the debtor's business cycle or the economy as a whole. Therefore, junior creditors have not been able to realize any upside that would come from a lengthier chapter 11 plan process. However, as will be discussed, the reality does not support this contention. Rather, empirical evidence shows that 363 Sales routinely generate contested auctions resulting in accurate and fair market value for the debtor's assets.

Calculating "Redemption Option Value"

Under the proposal, even if the fair market value of the debtor's assets (determined in connection with either a 363 Sale or a plan of reorganization) dictates that senior creditors would be entitled to all of the sale proceeds or the debtor's entire enterprise value in accordance with the absolute priority rule, in order for any 363 Sale or plan of reorganization to be approved, in certain circumstances discussed below, the approval order must provide for an allocation of value by holders of the fulcrum security (*i.e.*, the class of debt in the debtor's capital structure at which the firm's enterprise value is exhausted at the time of the enterprise valuation in the case) to the immediately junior class of debt or equity. The Redemption Option Value to be transferred would be the hypothetical value of an option to purchase the entire company and pay in full or "redeem" all of the outstanding senior debt. The value of this option would be calculated using a market-based model for pricing options, such as the Black-Scholes formula, which would take into account: (i) the strike price of the option, (ii) the term of the option, (iii) the volatility of the option, and (iv) an appropriate risk-free rate.

Under the proposal, the strike price for the option would be equal to the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus all interest, fees and expenses that would accrue through the end of the redemption period. The term or "redemption period" would generally be the period commencing on the effective date of the plan or closing of the sale and ending three years following the commencement of the case (*i.e.*, if the sale is consummated 6 months following the commencement of the bankruptcy case, the redemption period would expire 30 months following the sale). The volatility component of the formula would be determined by looking at the historical volatility of comparable companies, using an agreed upon volatility rate or using a set metric, and the risk-free rate generally would be based on the U.S. Treasury rate. The proposal contemplates that the junior creditors would not receive an actual option, but rather, the price that would be paid for such hypothetical option.

A redemption option value would not, however, be due in every instance. Where secured creditors are impaired and significantly underwater, junior creditors will likely not be entitled to any recovery based on the proposed formula. The closer the senior creditor class comes to being paid in full, however, the more value will be required to be transferred to junior creditors in order to allow the sale to close or plan to be confirmed.

Implications of the Proposal

Modification of Absolute Priority Rule

Obviously, one of the most significant implications of the Redemption Option Value proposal, should it be adopted, is that, in order to approve a 363 Sale or a plan of reorganization, value otherwise allocable to senior creditors would be required to be transferred to junior creditors despite the fact that senior creditors are not getting paid in full – something that is directly contrary to the absolute priority rule.

Increased Litigation and Expense

While the Report states that the proposal would serve to incentivize the major parties to reach a consensual reorganization, resulting in faster reorganizations and less litigation, the reality will likely be very different. If enacted, the proposal is likely to result in increased litigation over the amount of the Redemption Option Value and will likely be focused on the conflicting testimony of the parties' various experts regarding the future value of the company following bankruptcy. Rather than curtailing litigation, this proposal seems only likely to encourage it.

In addition, the Report itself acknowledges that while implementation in a relatively simple capital structure may be easy, the potential complexities of applying the proposed mechanism in more involved corporate and financing structures would be difficult. For instance, the Report leaves open how the proposal would be implemented where: (i) a senior class is entitled to less than all of the firm's enterprise value; (ii) contractual or structural subordination (rather than a lien) results in an immediately junior class; (iii) there are multiple classes senior to the immediately junior class and not all senior classes are receiving distributions in the form of interests in the residual value of the firm; (iv) only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or (v) some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full. Therefore, given the numerous issues left to be resolved, it is very likely that this proposal will only increase litigation and cost rather than decrease it.

The consequences of such additional complexity, litigation and expense are likely to be borne by senior creditors. Taken together with the Report's other proposals to extend the minimum time required to effect a 363 Sale, and to make it easier for debtors to secure new DIP financing without requiring the consent of the secured creditors, the proposals will likely result in further erosion of the secured creditors' collateral and recoveries and the shifting of leverage to the more junior out-of-the-money creditors with little to lose from the additional time and expense being financed (voluntarily or involuntarily) by the secured creditors' collateral.

Implications for Broader Credit Market

The Redemption Option Value proposal may also have unintended and negative consequences for the broader credit markets. The current 363 Sale process is widely understood by the credit industry and is generally perceived to result in auctions that are highly competitive and that result in accurate realizations of fair market value. Further, lenders providing credit do so with an understanding of the absolute priority rule and price credit accordingly. Any change to the current distribution system may very well have a substantial and negative effect on credit markets, particularly when so much credit has been given relying upon the accepted and current distribution scheme based upon the absolute priority rule. This has been proven by rating agencies, which have already indicated that the cost of credit would rise if these recommendations were enacted.[3]

Rationale for Proposal is Limited

Perhaps the most puzzling aspect of the Redemption Option Value proposal is that, given its substantial change to the absolute priority rule and the potential negative impact on the broader credit markets, such reform does not even appear to be necessary and the rationale for the proposed change at this time is limited at best. The Report states that reforms are required because sales occur too quickly, which prevents robust auctions, curtails the exploration of other restructuring alternatives and prohibits parties from performing reliable asset valuations. The Report concludes that this is "unfair" and hurts junior

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3 *See* Fitch Ratings Report, dated December 9, 2014, in which Fitch reported that the proposed reforms "could adversely alter recovery prospects of first lien debt claim holders."

creditors' recoveries as such creditors are not permitted to realize any upside that would come from a chapter 11 plan process or share in the possible future value appreciation of the affected assets.

However, there is no empirical or quantitative evidence that bankruptcy sales fail to generate accurate, fair market value for the assets being sold. In fact, quite the opposite is true. The market for distressed assets is robust and well-developed.[4] There is also no evidence that additional time exploring other restructuring options would lead to increases in value for out-of-the-money constituents. Rather, the only certainty is that longer cases will be more expensive. The proposal also seemingly glosses over the fact that, in many instances, the junior creditors that would obtain the new "protection" under the proposal are sophisticated financial institutions or investment funds that choose to invest in a particular part of the debtor's capital structure fully aware of the risk (lower recovery) and rewards (increased interest rate) associated with such choice. This proposal could reward those creditors that chose to receive higher interest payments and agreed to take on additional risk while hurting those creditors that chose to receive lower interest rates and invest in a safer portion of the capital structure.

4 *See, e.g., Mark Jenkins & David C. Smith, Creditor Conflict and the Efficiency of Corporate Reorganization*, (paper presented at April 2014 symposium), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444700.

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

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. First, the Report recommends amendments to § 363 (which they dub *"363(x)"*) that seek to lengthen the § 363 sale process. Second, 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[5]), 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

5 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

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.[6] 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."[7] 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."[8] Foreclosure Value would be "determined case by case based on the

6 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).

7 *Report* at 67.

8 *Id*. at 71.

evidence presented at the adequate protection hearing, taking into account the realities of the applicable foreclosure market and legal schemes."[9]

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.[10] 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

9 *Id*.

10 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.

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 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.

Your Blanket (Lien) May Have Holes: Proposed Amendments May Further Erode Secured Lenders' Rights

As discussed in the previous three installments, many of the proposals contained in the Report will have significant and negative implications for secured creditors. This is also true with respect to the Report's proposed amendments to § 552 of the Bankruptcy Code. This section establishes the extent and continuation of a creditor's prepetition security interests in a borrower's property following the commencement of a bankruptcy proceeding. The Report's proposed amendments to § 552 would codify a number of recent bankruptcy court decisions that have significantly damaged secured creditors' rights by limiting the reach of their prepetition liens on debtors' postpetition assets, thereby drastically reducing secured lenders' recoveries. Moreover, the proposed amendments go even further — by advocating that debtors be prohibited from waiving rights related to § 552 and lowering the related burden of proof, thereby making the importance of such rulings even greater. The decisions regarding § 552 (and the ABI's attempt to codify such decisions and limit the ability to mitigate such rulings) therefore pose a significant threat to secured creditors and should be carefully watched by all parties.

Section 552 and the Value of Secured Creditors' Collateral

Secured creditors have long assumed that if they possess a blanket lien on all of a borrowers' assets, such liens will capture a debtor's overall enterprise value, whether such value is created prior to or after the commencement date of a borrower's bankruptcy proceeding (the "*Petition Date*") pursuant to a chapter 11 reorganization or § 363 sale, up to the full face amount of their outstanding debt and all applicable interest and fees. For example, imagine the case of a loan to a distressed restaurant chain that is secured by a first priority blanket lien on all assets, including all equipment, food inventory and revenues. Typically, the lender's recovery in bankruptcy would not be limited to the liquidation value of the specific collateral, but rather, dependant upon the overall enterprise value of the business. Following any bankruptcy, creditors holding this debt would typically expect that any turn-around in the debtor's business, through the restructuring of its junior debt and rejection of unfavorable contracts, would significantly increase the value of the secured debt, allowing such creditor to capture any upswing in the debtor's overall value up to the amount of its debt.

It is only through the application of § 552, however, that prepetition secured creditors liens on collateral apply to a debtor's postpetition assets following a bankruptcy filing. This section, as currently enacted, cuts off all secured creditors' prepetition liens on property acquired by a debtor postpetition ***unless*** the applicable prepetition credit agreement includes a specific provision providing that the "***proceeds, products, offspring or profits***" of such prepetition property will continue to be subject to the prepetition lien following a debtor's bankruptcy filing.[11] This section also includes an important caveat to this rule, permitting courts discretion to find that the "equities of the case" mandate that prepetition liens should not

11 11 U.S.C. § 552(a) & (b)(1).

attach to the debtor's postpetition property. As drafted, § 552 is therefore critically important to not only the continuation of prepetition liens to postpetition collateral following a bankruptcy filing, but also to the overall value of secured creditors' debt.

Recent Legal Challenges to the Scope of § 552

Secured creditors' ability to use § 552 to extend their prepetition liens to postpetition collateral has, however, recently come under attack. In a number of important cases, unsecured creditors have been able to persuade certain bankruptcy courts to cut off secured lenders' rights to postpetition assets that most lenders assume are part of their overall collateral package, such as fixed assets and revenue. These decisions have largely hinged on the court's finding that postpetition acquired assets did not fall within the exact definitions of "proceeds, products, offspring, or profits."[12] For example, *In re Las Vegas Monorail Co.*,[13] the court took great lengths to find that secured lenders' prepetition liens in "contract rights" and "net project revenues" did not cover a debtor's postpetition income stream.[14]

Junior creditors have also used § 552's "equities of the case" exception to convince courts to find that a secured lender is only entitled to retain its liens on the proceeds of its prepetition collateral so long as no unencumbered assets have been used by a debtor to enhance or protect the secured assets at issue. In making this finding, courts have undertaken detailed examinations of the debtor's postpetition expenditures, tracing the source of funds utilized by the debtor during its bankruptcy case. Thus, where a secured creditor has a lien on all assets and no unencumbered assets are used to protect or improve a debtor's secured collateral, courts have allowed prepetition liens to attach to postpetition proceeds of such collateral and held that the "equities of the case" exception did not apply. For example, in *In re Laurel Hill Paper Company*,[15] the debtor used postpetition financing to pay the estate's expenses as well as all expenses related to a sale of certain assets secured by the lender's liens. The court found that, because no postpetition expenses were paid using unencumbered funds (rather only the postpetition funds received as part of the postpetition financing were used), the secured lender retained its liens over the postpetition collateral, was entitled to the all of the remaining proceeds from the sale (after repayment of the postpetition loan), and there was no support for an "equities of the case" award to the unsecured creditors.

However, where unencumbered assets — including "soft assets" such as the debtor's postpetition services — are employed to enhance or improve prepetition collateral, courts have invoked the "equities of the case" exception and chosen not to extend the prepetition liens to cover postpetition assets. For instance, in *In re Cafeteria Operators, L.P*,[16] secured lenders of a restaurant chain possessed a blanket lien on all of the debtors' assets and proceeds thereof. The secured lenders' collateral therefore included, among other things, the ingredients used in the food preparation, which can be secured by a filing under the Uniform Commercial

12 Importantly, none of these terms are defined in the Bankruptcy Code.

13 429 B.R. 317 (Bankr. D. Nev. 2010).

14 *See also*, In re Premier Golf Properties, LP, 477 B.R. 767, 774-75 (B.A.P. 9th Cir. 2012) (upholding bankruptcy court finding that a lender's lien in a debtor golf club operator (covering the debtor's personal property, general intangibles, license fees and "all proceeds thereof," and real estate, all rents, profits, issues, and revenues from the real property) did not extend to postpetition green fees or driving range fees); *In re Skagit Pacific Corp.*, 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004) (holding that despite prepetition liens on accounts receivable, postpetition accounts receivable were not included within the definition of "proceeds" where the revenue was derived, in part, from postpetition services performed by the debtor)

15 393 B.R. 89, 92 95 (Bankr. M.D.N.C. 2008).

16 299 B.R. 400 (Bankr. N.D. Tex 2003).

Code. The lien did not, however, cover the labor of the debtors' workers — a soft asset for which it is impossible to obtain a security interest. The Bankruptcy Court held that while certain portions of the debtors' revenues were proceeds of the collateral (specifically those parts attributable to the inventory), the portion attributable to the labor was not "proceeds" of the lender's collateral. Thus, the Bankruptcy Court held that the value of the secured creditor's interest in the postpetition revenues should be limited to the value attributed to its prepetition inventory based upon the "equities of the case" exception to § 552(b)(1). The court reasoned that to grant a blanket lien on all cash generated postpetition would represent a windfall to the secured creditor, in the face of the debtors' utilization of estate resources, *i.e.* their employees' labor, to increase the value of the secured creditor's collateral.[17]

A similar result was reached in *In re Residential Capital*.[18] In that case, junior secured noteholders ("*JSNs*") contended that they were entitled to postpetition interest, among other things, because they were over-secured based on the value of their pre- and postpetition collateral. In addition to holding certain liens on prepetition collateral, the JSN security agreement granted them a wide-reaching lien on all proceeds, products offspring, rents, issues, profits and returns of and from, and all distributions on and rights arising out of any of the collateral described in the JSN Security Agreement. Based upon these liens, the JSNs argued that they were entitled to the full going concern value of certain assets that had previously been sold postpetition to third parties, including both the liquidation value of those assets as well as the proceeds in the form of goodwill over and above the liquidation value.

After reviewing various expenditures made by the debtors as well as the source of the funds used, the Bankruptcy Court found that the debtors had used unencumbered estate resources — both property not subject to the secured creditors' liens as well as the debtors' soft assets, consisting of "time, effort and expense" — to enhance the value of the assets, thus generating an increase in the goodwill associated with the sale. Finding that §552(b)(1) only applies to collateral acquired postpetition that is "directly attributable to prepetition collateral, *without the addition of estate resources*," the Bankruptcy Court held that the JSNs had failed to meet their burden of establishing a lien on the goodwill portion of the amounts generated by the sale. Accordingly, the JSNs' claims were limited only to the liquidation value of their specific collateral and postpetition increases in goodwill were not attributed to the value of the JSNs' claims, thus prohibiting the JSNs from sharing in the overall postpetition increase in enterprise value.

As a result of these cases, secured creditors' recoveries have been limited to the value of the underlying collateral as of the petition date and the secured creditors' have not been able to share in postpetition increases in goodwill or overall enterprise value. While these cases are problematic for secured creditors, they have not yet had a significant impact on secured creditor recoveries more broadly because lenders have, in most cases, required debtors to waive their rights to assert challenges to liens under § 552 as part of a postpetition financing package. However, the Report's recommended amendments seek to change this, thereby making the effect of these cases much more significant to all secured creditors.

The Commission's Proposal

First, the Report recommends that the recent jurisprudence regarding the "equities of the case" be codified into the Bankruptcy Code. If adopted, such recommendations would be problematic for secured

17 *Id*. at 410.

18 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

creditors in that it would limit secured creditors' entitlement to postpetition proceeds of their collateral, including revenue and gains in overall enterprise value achieved after the commencement of a bankruptcy proceeding.

Perhaps more significantly, the Report goes even further than the current case law by proposing to lower the bar that a debtor must reach to show that the estate enhanced the value of the secured creditors' collateral for the purposes of § 552's "equities of the case" doctrine. The Commission asserts that a debtor should not be required to establish an actual expenditure of funds to evidence that the bankruptcy proceeding enhanced the value of the secured creditor's collateral using unencumbered assets. Rather, the Commission urges that a debtor should only be required to show evidence of any value provided, obligation incurred, or other action taken with respect to the secured creditor's collateral. Under the Commission's recommendation, a debtor could show evidence of the estate contributing value through evidence of the debtor's time, effort, money, property, other resources or cost savings.

Finally, the Commission recommends that § 552 be amended to prohibit a debtor from waiving its rights or entering into any agreement settling the value of a secured creditor's interest in the proceeds, products, offspring or profits of prepetition property. Under the Commission's proposal, debtors would be prevented from entering into any agreement (including a DIP financing agreement) that would limit a court's ability to make a determination based under § 552.

The Proposed Recommendations Will Have Negative Effects for All Secured Creditors

If enacted, these proposals would likely increase litigation costs of secured creditors (not to mention borrowing costs of borrowers) by encouraging junior creditors to challenge the liens of senior creditors as they relate to postpetition proceeds or value and requiring bankruptcy court judges to review each unique situation on a case-by-case basis, therefore creating greater uncertainty for secured creditors. Such uncertainty would be compounded by the Commission's proposed prohibition against waiving a debtor's rights under § 552 with respect to a secured creditor's collateral. The Report is even more troubling because when determining whether to limit a secured creditor's rights under the "equities of the case" doctrine, the Report would permit a debtor to show evidence that *any value* was provided — whether through time, effort, money, property, other resources, or cost savings — based on the facts underlying the bankruptcy proceeding.

Conclusion

The amendments to the Bankruptcy Code suggested in the Report, along with developing case law, could turn § 552 into a powerful weapon by which value may be wrested from secured creditors. As we have discussed in our prior client alerts, these proposals are not the law at this time, but may be influential to bankruptcy court judges. Further, if enacted, secured lenders would have to significantly reassess their recovery expectations in the event of default. Therefore, secured lenders and their advisors must maintain a vigilant eye on any efforts to implement these proposed reforms.

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

While the specific proposals contained in the Report will largely have significant and negative implications for 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.[19] 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."[20] 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,[21] 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

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

20 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.

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

22 *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).

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

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.[22] 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.[23] 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.[24] 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

24 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.

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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