



AMERICAN
BANKRUPTCY
INSTITUTE

2018 Bankruptcy Battleground West

I'm Gonna Make You an Offer You Can't Refuse! The Fight Between Secured Creditors and Junior or Unsecured Creditors in Bankruptcy

Scott F. Gautier, Moderator

Robins Kaplan LLP; Los Angeles

Ted A. Dillman

Latham & Watkins LLP; Los Angeles

Hon. Victoria S. Kaufman

U.S. Bankruptcy Court (C.D. Cal.); Woodland Hills

M. Reed Mercado

Sheppard, Mullin, Richter & Hampton LLP; Los Angeles

Educational Materials for the
2018 ABI Bankruptcy Battleground West
March 6, 2018

PANEL:

“I’M GONNA MAKE YOU AN OFFER YOU CAN’T REFUSE”

THE FIGHT BETWEEN SECURED CREDITORS AND

JUNIOR OR UNSECURED CREDITORS

IN CHAPTER 11 CASES

Panelists:

Ted A. Dillman
Latham & Watkins LLP

Hon. Victoria S. Kaufman
U.S. Bankruptcy Court (C.D. Cal.)

Ori Katz
Sheppard, Mullin, Richter & Hampton LLP

Moderator:

Scott F. Gautier
Robins Kaplan LLP

Secured Creditor Issues In Chapter 11

Secured lenders often work with debtors, creditors and committees in corporate chapter 11 cases to achieve a consensual approach to the use of cash collateral and post-petition financing. Through stipulated and consensual orders, these constituency often modify the environment in which the chapter 11 estate proceeds through the case in ways that can be consistent and predictable. The panel will examine some of the contemporary issues related to negotiated modifications and accommodations by and for secured lenders in cash-collateral stipulations, DIP financing agreements, bidding procedures orders and chapter 11 plans.

These materials supplement the panel discussion and present some of the underlying concepts and basic issues that will be discussed, in greater depth, by the panel.

I. DIP FINANCING AND CASH COLLATERAL ISSUES

A. Liens, Priming, Consent

One of the key elements of a bankruptcy filing is the ability to obtain postpetition financing (“DIP financing”) senior in priority to existing secured and unsecured debt – i.e., debt secured by “priming” liens. Under section 364 of the Bankruptcy Code:

- the trustee or debtor may obtain unsecured DIP financing with administrative expense status under sections 364(a) 364(b);
- if the trustee or debtor is unable to obtain unsecured DIP financing with administrative expense status, it may obtain DIP financing debt with super priority administrative expense status, which may be secured by a lien on unencumbered assets or a junior lien on encumbered assets under section 364(c); and/or
- if the trustee or debtor is unable to obtain DIP financing with super-priority administrative status and secured by junior liens, it may obtain DIP financing debt secured by a superior or equal lien on previously encumbered property under section 364(d), *provided that prepetition secured creditors are adequately protected*.

In practice, virtually all DIP financing is secured by all of the available protections, requiring that prepetition secured creditors be adequately protected (discussed in greater detail below). Due to the proliferation in secured debt over the past 15 years – and the development and

Secured Creditor Issues In Chapter 11

exponential growth of the second lien loan and secured high yield bond markets over this period – secured debt frequently represents a high percentage (or all) of the debtor’s value.

As a result, demonstrating adequate protection has become increasingly difficult (or impossible in many instances), and almost all priming DIP financing is now provided with the consent of, and usually by, existing prepetition secured creditors who consent to priming of their liens in exchange for a negotiated adequate protection arrangement. Moreover, as syndicates of lenders increasingly provide credit facilities, and as capital structures have become more complex and frequently include multiple tranches of secured debt, who controls the right to consent has become increasingly important. These issues are resolved almost exclusively under the transaction documents themselves. For instance, under most syndicated credit agreements, the agent (which is the holder of the lien for the loan), will act at the direction of the so-called “required” or “requisite” lenders (typically a majority in amount) and will have the exclusive right to exercise remedies and take action related to the collateral. Similarly, under the waiver and amendment provisions of most syndicated credit agreements, while *release* of liens on all or substantially all of the collateral is often a “sacred” right requiring all affected lender consent (or a higher threshold), *subordination* of liens typically is not and can be effectuated with required lender consent.

In first/second lien or crossing lien structures, inter-creditor agreements usually govern the secured parties’ rights (and subordination agreements are specifically made enforceable in bankruptcy by section 510 of the Bankruptcy Code). Typical first lien/second lien inter-creditor agreements will provide the first priority creditor the right to provide DIP financing (often up to a cap) and to consent to use of cash collateral. In such instances, the junior creditor will typically be deemed to consent on matters to which the senior creditor has consented, with specified limited

Secured Creditor Issues In Chapter 11

rights to request adequate protection replacement liens and super-priority administrative claims that are junior to the adequate protection package provided to the senior creditor.

However, documents are drafted with a wide-variety of specificity and, while courts have increasingly trended towards enforcing inter-creditor agreements, to the extent such agreements restrict parties from making competing financing proposals or taking other actions that will inure to the debtor's benefit, courts have often read inter-creditor agreements narrowly, heightening the importance of careful drafting. For instance, in *Aurelius Capital Master, Ltd. v. TOUSA Inc.*, 2009 WL 6453077 (S.D. Fla. Feb. 6, 2009), the second lien lenders objected to the use of cash collateral to fund the creditors' committee's investigation of liens and pursuit of claims against them; however, the bankruptcy court approved the cash collateral order over this objection, enforcing the terms of the inter-creditor agreement, which provided that the second lien lenders were deemed to consent to the use of cash collateral if the first lien lenders consented. On the other hand, in *In re MPM Silicones*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014) ("Momentive"), the first lien lenders alleged that the second lien lenders breached the inter-creditor agreement by allegedly supporting priming DIP financing (to which the first lien lenders did not actually object). The court rejected this claim because although the inter-creditor agreement prohibited the second lien lenders from objecting to DIP financing supported by the first lien lenders, there was no provision in the inter-creditor agreement prohibiting the second lien lenders from supporting other DIP financing. As such, when examining waivers of bankruptcy objections and creditor's rights in inter-creditor agreements and other credit documents, the documentation is the critical foundation for the inquiry. Absent consent, the debtor must prove adequate protection, which, as discussed further below, is frequently difficult (if not impossible).

Secured Creditor Issues In Chapter 11

B. Adequate Protection Issues

Under various provisions of the Bankruptcy Code, prepetition secured creditors are entitled to “adequate protection.” As the term would imply, adequate protection is designed to protect prepetition secured creditors from diminution in value of their collateral that results during a bankruptcy case. Specifically, adequate protection is required to under section 363(e) of the Bankruptcy Code in connection with any use, sale or lease of a secured creditors’ collateral (including cash collateral). Similarly, under section 364(d) of the Bankruptcy Code, in order for DIP financing to be secured by priming lines, prepetition secured creditors must be adequately protected, and section 362(d) of the Bankruptcy Code provides that a lack of adequate protection is cause for relief from the automatic stay.

Section 361 of the Bankruptcy Code provides three means for a debtor to provide adequate protection:

- (1) requiring the trustee or debtor in possession to make periodic cash payments to such entity, to the extent that . . . any grant of a lien under section 364 . . . results in a decrease in the value of such entity’s interest in such property;
- (2) providing to such entity an additional or replacement lien to the extent that such grant results in a decrease in the value of such entity’s interest in such property; or
- (3) granting such other relief . . . as will result in the realization by such entity of the indubitable equivalent of such entity’s interest in such property.

As part of the agreement for the debtor’s use of the prepetition secured creditor’s cash collateral and/or in connection with priming DIP financing, the secured creditor will receive a negotiated adequate protection package. This package generally includes – to the extent of any diminution in value of the secured creditor’s collateral – liens on unencumbered assets, replacement liens on assets acquired postpetition, and super-priority administrative claims under

Secured Creditor Issues In Chapter 11

section 341(c)(1) of the Bankruptcy Code (which adequate protection liens and super-priority administrative claims will typically be junior to any liens and superiority administrative claims securing DIP financing, but senior to all other liens and administrative claims (other than the professionals' carve-out)). Further, to the extent the adequate protection provided to the secured creditor proves inadequate to protect the secured creditor from diminution in value of its collateral resulting from imposition of the automatic stay under section 362, the use, sale or lease of collateral under section 363, or from the grant of any priming lien under section 364(d), the secured creditor's administrative claim is entitled to priority over all other administrative claims. Finally, particularly for over-secured creditors, the adequate protection package will frequently include payment of professional fees and ongoing interest payments to which the secured creditors would be entitled under section 506(b). The United States Trustee and creditors' committee will typically require that fee and interest payments will be subject to re-characterization as principal payments to the extent the secured creditor is ultimately determined to be under-secured.

As noted above, in at least the vast majority of larger chapter 11 cases, secured creditors consent to the use of cash collateral or grant of priming liens securing DIP financing (typically the prepetition secured creditor will be providing the DIP financing) in exchange for a negotiated adequate protection arrangement. However, absent the secured creditor's agreement, the debtor will be required to prove that the secured creditor is adequately protected.

Proving adequate protection (which is the debtor's burden under section 364(d)(2) and requires supporting evidence), is generally approached in one of two ways. First, the debtor may argue that the secured creditor is adequately protected by an "equity cushion" in its collateral – i.e., the value of the lienholder's collateral exceeds the secured debt by a sufficient amount so that the addition of priming secured debt will not increase the payment risk for existing secured claims.

Secured Creditor Issues In Chapter 11

See *In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010) (“The existing [sic] of an equity cushion seems to be the preferred test in determining whether priming of a senior lien is appropriate under section 364”) (internal quotations omitted); *Wilmington Trust Co. v. AMR Corp. (In re AMR Corp.)*, 490 B.R. 470, 478 (S.D.N.Y. 2013) (finding “the existence of an equity cushion can be sufficient, in and of itself, to constitute adequate protection”); *In re Grant Broadcasting*, 75 B.R. 819, 823–24 (E.D. Pa. 1987) (authorizing the debtor’s use of cash collateral where a 22% equity cushion existed and the cash collateral would be used to fund the debtor’s necessary operating expenses). If an existing equity cushion is eroding or likely to erode, the court will likely require additional adequate protection. See *In re Jer/Jameson Mezz Borrower II, LLC*, 461 B.R. 293, 305 (Bankr. D. Del. 2011). Where a debtor can present evidence to support an equity cushion, this may be the easier path; however, debtors rarely have valuations, appraisals and experts at the outset of their cases to present evidence establishing adequate protection through an equity cushion.

If the debtor cannot establish an equity cushion cannot, the debtor may argue (usually in the use of cash collateral context) that the continued operation of the business and grant of replacement liens on postpetition collateral constitutes adequate protection because the continuing operation of the business preserves or enhances collateral value. For instance, in *In re Dynaco Corp.*, 162 B.R. 389, 397 (Bankr. D.N.H. 1993), the court noted that the relevant issue in determining adequate protection in connection with cash collateral usage was “whether the level of the fluctuating collateral involved will be maintained.” In these instances, the debtor would seek to demonstrate that the debtor’s operations are likely to maintain or increase the value of the collateral. See *Principal Mut. Life Ins. Co. v. Atrium Dev. Co. (In re Atrium Dev. Co.)*, 159 B.R. 464, 471 (Bankr. E.D. Va. 1993) (“[a]dequate protection is typically established by the fact that

Secured Creditor Issues In Chapter 11

the cash is being used to maintain and enhance the value of the underlying income producing real property in which the creditor also usually holds a security interest”); *In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 105 (Bankr. S.D.N.Y. 1991) (authorizing debtor’s use of cash collateral to operate and maintain office building, thereby protecting secured lender’s collateral and existing equity cushion).

While trustees or debtors will occasionally seek to approval of non-consensual cash collateral usage (or even less frequently, priming DIP financing), such proceedings are relatively uncommon due to the challenge of proving adequate protection.

II. COMPROMISES ON COSTS AND SURCHARGES

A. Professional Fee Carve-Outs and 506(c) Waivers

A common trade-off in negotiated consensual cash-collateral and DIP financing orders is the provision of a “Carve-Out” to pay professional fees by the secured lender(s) and, in exchange therefore, a waiver of the estate’s right to surcharge the secured lender’s collateral for costs of administration of the chapter 11 estate pursuant to Bankruptcy Code section 506(c). Issues can arise, and are sometimes overlooked, when a senior secured lender has consented to a Carve-Out and received a waiver from 506(c) charges, but the junior secured lender, with respect to the exact same collateral, has not consented to a Carve-Out and has not received a waiver from section 506(c) surcharge.

Section 506(c) of the Bankruptcy Code provides:

(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.

Aside from the consent of secured creditors, the trustee lacks the ability to use the proceeds of a secured creditor’s collateral unless the proceeds are paid to the secured creditor or

Secured Creditor Issues In Chapter 11

there are sufficient unencumbered replacement assets available to adequately protect the secured creditor from the use of its collateral. However, Section 506(c) allows the trustee to surcharge the secured creditor for the same types of costs that the secured creditor would typically incur if the secured creditor sought to liquidate the collateral on its own. *See Loudoun Leasing Development Co. v. Ford Motor Credit Co. (In re K & L Lakeland, Inc.)*, 128 F.3d 203 (4th Cir. 1997); *In re TIC Memphis RI 13, LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013). Hence, section 506(c) can provide significant uncertainty for the secured creditor with respect to what charges may be incurred and, in turn, leverage for the trustee or debtor in possession to extract concessions in exchange for certainty with respect to the amount of surcharge that the secured creditor will need to bear.

Interestingly, while the trade-off of “professional fee carve-out for 506(c) surcharge waiver” has become commonplace, it is notable that professional fees, in general, are not necessarily the types of fees and costs that were intended to be covered by the 506(c) surcharge. For an expense to qualify to be paid from a 506(c) surcharge of collateral: (i) the expenditure must be necessary; (ii) the amounts expended must be reasonable; and (iii) the secured creditor must benefit from the expense and the trustee has the burden of establishing those elements. *See* 4 COLLIER ON BANKRUPTCY ¶ 506.05[9] (16th ed. 2014). Nonetheless, the carve-out / 506(c) waiver compromise is one way in which secured creditors agree to “pay the freight” in a chapter 11 case.

B. Other Considerations for “Paying the Freight”

In the wake of BAPCPA, the Delaware bankruptcy courts made clear that in the sale of encumbered assets, the secured creditor would have to carve-out some of the sale proceeds (“carve-outs”) to holders of administrative priority claims, including 503(b)(9) claims. This led to the proliferation of detailed carve-out agreements, pursuant to which secured creditors agreed to the amounts to be paid to professionals and other holders of other administrative claims.

Secured Creditor Issues In Chapter 11

However, *In re KVN Corp.*, a Ninth Circuit Bankruptcy Appellate Panel case, increased the judicial scrutiny of such agreements. Significantly, the court held that in the case of a sale of fully encumbered estate property “a rebuttable presumption of impropriety” arises with respect to the carve-out agreement. In order to rebut the presumption, it must be demonstrated that the sale will result in a “meaningful distribution” to unsecured creditors. As such, in connection with carve-out agreements, the parties must take into account all expenses incurred by an estate in a sale transaction and compare them to the anticipated distribution to creditors. For example, a distribution to professionals that is larger than the one to unsecured creditors may not constitute a “meaningful distribution.” Note that KVN was a chapter 7 case, though it is often cited in the context of chapter 11 cases being run for the benefit of the secured creditor and professionals alone.

Consider recent cases of Anna’s Linens (C.D. Cal.) and WYNIT (D. Minn) as examples of mid-market debtors navigating the issue, including use of set-asides designated for payment of certain classes of claimants.

III. PLAN AND SALE CONSIDERATIONS AND ISSUES

A. Secured Claims in Cramdown Plans

A debtor can force (or “cramdown”) a plan on a secured creditor if the plan provides that the secured creditor will retain its lien and that it will receive payments over time with a present value of at least the amount of the secured claim. The secured claim (and the present value the secured creditor must receive) is equal to the value of the collateral. Under the United States Supreme Court case *Rash*, that value is to be based on the “replacement-value standard” rather than the “foreclosure-value standard” because the former is generally greater than the latter.

However, the opposite was true in *In re Sunnyslope Housing, L.P.*, a 2017 Ninth Circuit case. There, the foreclosure value was more than the replacement value because a foreclosure would have wiped out certain restrictive covenants on the real property collateral. Nevertheless,

Secured Creditor Issues In Chapter 11

the Ninth Circuit held that under *Rash*, the value had to be the lower replacement value, even though the Supreme Court case was intended to benefit secured creditors.

Interestingly, the creditor in *Sunnyslope* was precluded from objecting to the cramdown plan under the best interests test because the creditor had elected to have its entire claim treated as secured under Bankruptcy Code section 1112(b)(2). Had it not made that election, it would have had a potentially meritorious objection because it would not have received as much under the plan as it would under a hypothetical Chapter 7 liquidation. Note also that the Ninth Circuit seemed to factor in the lender's discounted purchase of the underlying debt.

B. Credit Bidding Concerns

Section 363(k) of the Bankruptcy Code provides that a secured creditor can offset the amount of the secured claim against the purchase price of the debtor's assets, except "for cause". For years, the "for cause" exception was limited to a bona fide dispute over the validity of the secured claim or the lien itself, or to the secured creditor's misconduct. However, *In re Fisker Automotive Holdings, Inc.*, a 2014 Delaware bankruptcy case, expanded the "for cause" exception to encompass a new element.

In the case, the secured creditor purchased the debtor's \$168,500,000 debt for \$25,000,000 and negotiated to purchase the debtor's assets for a \$75,000,000 credit bid. The committee objected on the grounds that there was a competing bidder that would only participate if the credit bid was limited to \$25,000,000. If the credit bid was not limited, the committee argued that "there [would be] no realistic probability of an auction." The court held that a "court may deny a lender the right to credit bid in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." The court then found that absent a limit on the credit bid, the bidding environment would not just be chilled, but frozen. It is important to note that the court also

Secured Creditor Issues In Chapter 11

relied on some of the more traditional “for cause” exception factors, finding that the secured creditor had insisted on an unfair and hurried sale process, and that the validity of its secured status had yet to be determined.

The scope of *Fisker* seems to have been abrogated in 2016 in the Southern District of New York bankruptcy case *In re Aeropostale*. In the case, the secured creditor’s right to credit bid was challenged. After concluding that there had been no creditor misconduct, the court held that the fact that credit bidding would chill bidding at the auction, without more was insufficient to satisfy the “for cause” exception. The court relied on the cited misconduct in *Fisker* to differentiate the cases. But, consider the dicta in *In re Sunnyslope Housing, L.P.* regarding the court’s consideration of the price at which a secured lender purchased its debt, in taking into account overall treatment afforded to that creditor.