Recent Decisions Affecting Secured Creditor Rights and the Potential Impact of Such Cases

David M. Hillman, Moderator
Schulte Roth & Zabel LLP

Hon. Stuart M. Bernstein
U.S. Bankruptcy Court (S.D.N.Y.)

Ronen A. Bojmel
Guggenheim Partners, LLC

Marc J. Heimowitz
Claren Road Asset Management

Daniel B. Kamensky
New York

Madlyn G. Primoff
Kaye Scholer LLP

Brian Trust
Mayer Brown LLP

Valuation Panel: Recent Decisions Affecting Secured Creditor Rights and the Potential Impact of Such Cases

ABI 17th Annual New York City Bankruptcy Conference

May 14, 2015

Hon. Stuart M. Bernstein, U.S. Bankruptcy Court (S.D.N.Y.)
Ronen Bojmel, Guggenheim Partners
Marc J. Heimowitz, Claren Road Asset Management
Daniel B. Kamensky
Madelyn G. Primoff, Kaye Scholer LLP
Brian Trust, Mayer Brown LLP
Moderated by
David M. Hillman, Schulte Roth & Zabel LLP

Index

I. **Bankruptcy Court Approves Non-Market Cramdown Rate on Momentive Secured Creditors**

II. **Credit Bid Buyers Beware: Delaware Bankruptcy Court Caps Credit Bid**

III. **ABI Commission Report: Highlights of Proposed Chapter 11 Reforms**

IV. **Priming DIPs: The New Normal?**

V. **ABI Commission Report Recommendations on DIP Financing Would Eliminate Lender Protection**

VI. **"Redemption Option Value": Mandatory Distributions to Out-of-the-Money Stakeholders**

VII. **Asset Sales: ABI Commission's Recommendations Could Make Value Realization by Secured Creditors a Waiting Game of Diminishing Returns**

VIII. **Leveraged Lending & High Yield Bond Market Statistics**

Schulte Roth & Zabel

Alert

Bankruptcy Court Approves Non-Market Cramdown Rate on Momentive Secured Creditors

October 15, 2014

On Aug. 26, 2014, the Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") issued an oral bench ruling in connection with Momentive Performance Materials Inc.'s and its affiliated debtors' (collectively, the "Debtors") request for confirmation of their joint Chapter 11 plan of reorganization.[1] While the ruling disposed of various matters relating to the proposed plan and confirmation, this *Alert* addresses the Bankruptcy Court's decision on the interest rate that must be paid on account of new debt securities to be issued to a non-accepting class of secured creditors in a "cramdown" under Section 1129(b) of the Bankruptcy Code. As discussed in this *Alert*, this ruling could potentially have far-reaching implications not only on the returns that investors in secured debt can expect but also on the availability and pricing of capital for distressed and non-distressed borrowers generally.

The Debtors' Proposed Plan and Cramdown Provisions

The cramdown issue arose from the plan's proposed treatment of the claims of the first lien and so-called "1.5 lien holders."[2] Under the plan, if the class of first and/or 1.5 lien holders voted to accept the plan, then those holders would be entitled to payment in full, in cash, of the allowed amount of their respective secured claims (including all accrued and unpaid pre- and post-petition interest, but without any make-whole premium).[3] If, on the other hand, the first and/or 1.5 lien holders voted to reject the plan, then their claims would be satisfied, not by cash, but through the issuance of replacement notes. The replacement notes would be secured and their principal amounts would be equal to the principal amount of the allowed claims (including accrued and unpaid pre- and post-petition interest and make-whole premium, if any).[4] The first lien replacement notes would mature in seven years and bear interest at a rate equal to the seven-year Treasury rate plus 1.5 percent, which, as of the date of the bench

[1] *See In re MPM Silicones LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive*"). Note that this *Alert* cites to the transcript as it was corrected and modified by the Bankruptcy Court (and reported) subsequent to its initial oral ruling made on Aug. 26, 2014.

[2] The 1.5 lien holders held claims secured by liens ranking below those held by the first lien holders, but above the liens of the second lien debt holders.

[3] *See Momentive* at 11. By voting to accept the plan, however, those classes would be waiving their respective claims to make-whole premiums. *Id.* Additionally, the Debtors had secured loan commitments from lenders under takeout and bridge facilities to fund this "cash-out alternative," if accepted by the first and/or 1.5 lien holder classes. *Id.* at 29. For further discussion regarding the make-whole issue, please see the SRZ *Alert* "New York Bankruptcy Judge Disallows Payment of Make-Whole Premium," available at www.srz.com/New_York_Bankruptcy_Judge_Disallows_Payment_of_Make-Whole_Premium.

[4] Upon such rejection, the holders' respective rights to argue that they were entitled to the make-whole premiums, and therefore to include such premiums in the allowed amounts of their claims, would be preserved.

ruling, implied a coupon of approximately 3.6 percent.[5] The 1.5 lien replacement notes would mature in seven and a half years and the applicable rate would be the seven-and-a-half-year Treasury rate plus 2 percent, implying a coupon of approximately 4.1 percent as of the date of the bench ruling.[6]

The plan was resoundingly rejected by both the first lien and 1.5 lien holders: Approximately 90 percent of the first lien class and over 80 percent of the 1.5 lien class (both in amount and number in each case)[7] voted to reject the plan.[8] The Debtors argued that, notwithstanding such rejection, the plan nevertheless satisfied the cramdown requirements set forth in section 1129(b) of the Bankruptcy Code and could therefore still be confirmed by the Bankruptcy Court.

Section 1129(b) of the Bankruptcy Code sets forth the means by which a plan that is not accepted by all impaired creditors and equity holders can nonetheless be confirmed. The Bankruptcy Code provides in relevant part:

> Notwithstanding section 510(a) of [the Bankruptcy Code], if all of the applicable requirements of [section 1129(a) of the Bankruptcy Code] other than [the requirement that a plan must be accepted by all impaired classes] are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph *if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan*.[9]

As the Debtors argued, under Section 1129(b)(1) "a Bankruptcy Court may cram down a plan over the dissenting vote of an impaired class or classes of claims or interests as long as the plan does not 'discriminate unfairly' and is 'fair and equitable' with respect to the non-accepting class."[10]

With respect to the first and 1.5 lien holders specifically, the Debtors argued that the plan was fair and equitable because it satisfied the requirements of Section 1129(b)(2)(A) of the Bankruptcy Code.[11] Section 1129(b)(2)(A) establishes the scenarios by which the fair and equitable condition with respect to a dissenting class of secured creditors can be satisfied.[12] In particular, for a plan to be fair and equitable to secured creditors, it must provide:

> (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

---

[5] *See Momentive* at 24.

[6] *Id.*

[7] Acceptance of a plan by a class of creditors requires acceptance by two-thirds (66.67 percent) in amount and more than one-half (50 percent) in number of the qualified creditors in that class. *See* Bankruptcy Code § 1126(c).

[8] *See Debtors' (I) Memorandum of Law in Support of Confirmation of Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. and its Affiliated Debtors and (II) Omnibus Reply to Objections with Respect to Plan and Related Adversary Proceedings*, Case No. 14-22503, 8 (Bankr. S.D.N.Y.) [Docket No. 814] ("Debtors' Confirmation Brief").

[9] Bankruptcy Code § 1129(b)(1) (emphasis added).

[10] Debtors' Confirmation Brief at 56 (citing Bankruptcy Code § 1129(b)(1); other internal citations omitted).

[11] *See* Debtors' Confirmation Brief at 61; Bankruptcy Code § 1129(b)(2)(A). The Debtors also argued that the plan did not discriminate unfairly. *See* Debtors' Confirmation Brief at 57-59.

[12] *See* Debtors' Confirmation Brief at 62 (citing Bankruptcy Code § 1129(b)(2)(A)).

> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property … .[13]

The Debtors argued that their plan as proposed satisfied these requirements of Section 1129(b)(2)(A)(i) of the Bankruptcy Code.[14] Specifically, the Debtors stated that, under the plan, the first and 1.5 lien holders would: (1) retain their respective liens on their prepetition collateral to the extent of their allowed claims; and (2) receive replacement notes with deferred payments with a present value, as of the effective date of the plan, of at least the amounts of their respective claims.[15]

The key issue before the Bankruptcy Court related to the latter point, namely, what the appropriate rate of interest — the so-called "cramdown rate" — would have to be in order to ensure that the first and 1.5 lien holders received, on a present value basis, the equivalent of the allowed amount of their respective claims.[16] The Debtors argued that, based on the 2004 decision of the United States Supreme Court in *Till v. SCS Credit Corp.*,[17] the appropriate cramdown rate was to be determined using a "formula" approach.[18] The Debtors described the *Till* formula approach as having two steps:

> [T]he first step is to choose an applicable base rate, which is selected "taking [a] cue from ordinary lending practices" reflecting the "financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relative slight risk of default." … The second step of the *Till* formula is to adjust the base rate to "account for the risk of nonpayment posed by borrowers in their financial position."[19]

This approach, the Debtors argued, justified setting the interest rates for the first and 1.5 lien replacement notes as "the Treasury Rate, a suitable base rate to reflect the long-term maturity of such notes, plus 1.50 percent and 2.0 percent, respectively, to account for certain risks."[20] As noted above, based on prevailing Treasury rates at the time, this approach yielded effective rates of approximately 3.6 percent for the first lien replacement notes and 4.1 percent for the 1.5 lien replacement notes.

The Indenture Trustees' Objections

The indenture trustees for each of the first and 1.5 lien notes objected to the cramdown rates proposed by the Debtors, arguing that those rates did not satisfy the present value test under Section

---

[13] Bankruptcy Code § 1129(b)(2)(A). Section 1129(b)(2)(A) also provides for two alternative scenarios, not relevant to this discussion, by which a plan may be considered fair and equitable to secured creditors. *See* Bankruptcy Code § 1129(b)(2)(A)(ii) and (iii).

[14] *See* Debtors' Confirmation Brief at 62-63 (citing Bankruptcy Code § 1129(b)(2)(A)(i)).

[15] *See* Debtors' Confirmation Brief at 63. *See also Debtors' Omnibus Reply to Cramdown Objections to the Debtors' Joint Chapter 11 Plan of Reorganization*, Case No. 14-22503, 9 (Bankr. S.D.N.Y.) [Docket No. 867] (internal citations omitted).

[16] *See Momentive* at 24.

[17] 541 U.S. 465 (2004) ("*Till*"). For a more detailed discussion of *Till* and related cases, please refer to Chapter 21 of *Bankruptcy Litigation Manual* (M. Cook ed., 2013-2014). A copy may be obtained by contacting one of the authors.

[18] Debtors' Confirmation Brief at 63 (citing *Till* at 479).

[19] Debtors' Confirmation Brief at 64 (citing *Till* at 479, 471).

[20] Debtors' Confirmation Brief at 64.

1129(b)(2)(A)(i) of the Bankruptcy Code and that they should instead be higher, market-based rates.[21] The principal thrust of their objections can be summarized as follows:

- *The Supreme Court's decision in* Till *should not be applied to this case*.[22] The indenture trustees argued that the approach applied in *Till* was inapplicable here because the debtors in that case were individuals who had filed under Chapter 13 of the Bankruptcy Code (which governs debt adjustment by individual debtors) and were seeking to restructure a loan secured by a used truck. The circumstances of this case relating to business debtors and commenced under Chapter 11 of the Bankruptcy Code were clearly different from those of *Till*, and therefore, the indenture trustees argued, *Till* was not binding precedent and should not be applied to this case.
- *The* Till *decision acknowledged that if an efficient market for financing exists, then the cramdown rate should equal the market rate of interest*.[23] The indenture trustees further argued that even if *Till* were applicable, the Supreme Court in that case expressly acknowledged that in Chapter 11, it is appropriate to first determine if an efficient market for financing exists before applying the formula approach. On this point, the indenture trustees argued that applying the formula approach made sense in *Till* (a Chapter 13 case) because of the "absence of a free market for loans to chapter 13 debtors," but "where there is a free market of willing debtor-in-possession and exit lenders, [the Supreme Court expressly acknowledged that] 'it might make sense to ask what rate an efficient market would produce.'"[24] Further, they argued that an efficient market for financing did exist in this case (a Chapter 11 case), as evidenced by expert testimony and the fact that the Debtors had secured commitments for a $1-billion exit facility and a $250-million bridge facility.[25] Thus, as the 1.5 lien indenture trustee concluded, "because the Debtors [participated] in an efficient financing market and [had] commitments to refinance the 1.5 Lien Notes through a third-party bridge loan, the Supreme Court's guidance [indicated] that a *market rate* [was] the appropriate cramdown interest rate for the Replacement 1.5 Lien Notes."[26] The indenture trustees also argued that the rates reflected in the exit and bridge facilities could be used as fair proxies for the *Till* formula rates.[27]
- *Even under the* Till *formula approach, the Debtors' cramdown rates are not fair and equitable*.[28] Finally, the indenture trustees argued that even if the formula approach under *Till* were

[21] *See Momentive* at 24. *See also generally Objection of BOKF, NA, as First Lien Trustee, to the Debtors' Joint Chapter 11 Plan and Confirmation of the Plan with Respect to the Terms of the Replacement First Lien Notes*, Case No. 14-22503 (Bankr. S.D.N.Y) [Docket No. 820] ("First Lien Cramdown Objection") and *Cramdown Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of Debtors' Proposed Joint Chapter 11 Plan of Reorganization*, Case No. 14-22503 (Bankr. S.D.N.Y.) [Docket No. 813] ("1.5 Lien Cramdown Objection").

[22] *See generally* First Lien Cramdown Objection at 2, 14-15 and 1.5 Lien Cramdown Objection at 15-18.

[23] *See generally* First Lien Cramdown Objection at 17-20 and 1.5 Lien Cramdown Objection at 13-15, 18-23.

[24] 1.5 Lien Cramdown Objection at 14 (citing *Till* at 476 n.14).

[25] Those facilities, as noted above, had been obtained to fund, among other things, the cash-out option for the first and 1.5 lien holders. *See Momentive* at 29. Further, the rates provided under those facilities were higher than those under the replacement notes. *Id*. The rate for the exit facility was LIBOR plus 4 percent (with a LIBOR floor of 1 percent), for an implied effective rate of 5 percent (and an alternative rate of 6.25 percent at the debtors' option). *Id*. The rate for the bridge facility was LIBOR plus 6 percent, increasing in increments of 50 basis points and subject to a cap. *Id*.

[26] 1.5 Lien Cramdown Objection at 23 (internal citations omitted) (emphasis added). It should be noted that both the first lien indenture trustee and 1.5 lien indenture trustee adduced evidence specifying the appropriate market rates that they argued should be applied in lieu of the debtors' chosen cramdown rates. That evidence, however, was filed under seal and is currently not publicly available.

[27] *See Momentive* at 29.

[28] *See generally* First Lien Cramdown Objection at 20-36 and 1.5 Lien Cramdown Objection at 28-33.

appropriate and applicable in these circumstances, the actual rates designated in the plan were not fair and equitable.[29] First, the indenture trustees took issue with the use of Treasury rates as the base rate, and not the prime rate, as applied in *Till*.[30] The prevailing national prime rate at the time was 3.25 percent, whereas the applicable Treasury rates were 2.14 percent and 2.20 percent (i.e., lower).[31] Thus, as the indenture trustees argued, use of the lower Treasury rates as the base rates (without any corresponding upward adjustments to the risk premiums) would effectively deprive the first and 1.5 lien holders of more than 1 percent to which they would otherwise be entitled under a proper application of *Till*.[32] Second, the indenture trustees argued that the risk premiums applied by the Debtors (i.e., 1.5 percent and 2 percent, respectively) were inadequate in that they failed to adequately adjust for the risks attendant to lending to these Debtors, including credit risk relating to the circumstances of the estates, the nature of the security, and plan feasibility and duration.[33]

The Bankruptcy Court's Ruling

The Bankruptcy Court rejected the indenture trustees' objections and agreed to enter an order confirming the plan, subject to certain adjustments to the cramdown rates as discussed below.[34]

With respect to the indenture trustees' objections, the Bankruptcy Court held that:

- *The* Till *formula approach is appropriate in chapter 11 cases*. The Bankruptcy Court found that "there [was] no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the similarity of the language of the … [analogous] provisions [under each chapter] and the underlying present value concept that *Till* recognized should be applied uniformly throughout the [Bankruptcy] Code."[35] The Bankruptcy Court also stated that it was guided by the principles enunciated by the plurality decision in *Till* as well as an earlier Second Circuit decision cited favorably in *Till*, both of which cases established key "first principles" for setting the appropriate discount rate for cramdown purposes of a secured claim.[36] Those first principles were that, first, the cramdown interest rate should *not* contain any lender profit or cost element and, second, that market-based evidence should not be considered except to determine a risk premium, all as discussed further below.[37] The Bankruptcy Court thus concluded that the *Till* approach was appropriate for this case.[38]
- *The market should not be considered in determining the cramdown rate, except in determining the risk premium (which will normally be between 1 percent and 3 percent)*. The Bankruptcy

[29] *Id.*

[30] See *Till* at 478-79 ("[T]he approach begins by looking to the national prime rate, reported daily in the press … [T]he approach then requires a bankruptcy court to adjust the *prime rate* accordingly" (emphasis added).).

[31] *See* First Lien Cramdown Objection at 24 and 1.5 Lien Cramdown Objection at 28.

[32] *Id*.

[33] *See generally* First Lien Cramdown Objection at 26-33 and 1.5 Lien Cramdown Objection at 29-33.

[34] *See Momentive* at 34.

[35] *Id.* at 24.

[36] *Id.* at 25 (referring to *Till* and *In re Valenti*, 105 F.3d 55 (2d Cir. 1997) ("*Valenti*")).

[37] *Id.* at 26.

[38] *Id.* at 29.

Court also rejected the indenture trustees' argument that market evidence should be considered in determining the cramdown rate, other than, possibly, to set the appropriate risk premium in the second step of the *Till* formula approach: "[t]he cramdown rate analysis … should focus on a rate that does not take market factors into account … [M]arket-based evidence should not be considered, except, arguably and, if so secondarily, when setting a proper risk premium in the formula approach."[39] The Bankruptcy Court reiterated that under the formula approach, the proper cramdown rate "begins with a risk-free base rate, such as the prime rate used in *Till*, or the Treasury rate used in *Valenti*, which is then adjusted by a percentage reflecting a risk factor based on the circumstances of the debtor's estate, the nature of the collateral security and the terms of the cramdown note itself and the duration and feasibility of the plan."[40] The Bankruptcy Court noted that both the Supreme Court and Second Circuit had held that the risk adjustment should generally be between 1 percent and 3 percent.[41]

The Bankruptcy Court also held that the objective of the cramdown provisions of the Bankruptcy Code with respect to secured creditors is to "put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately," and *not* to account for any profit or costs of the creditor.[42] On this point, the Bankruptcy Court quoted the Second Circuit in *Valenti*, stating: "The purpose [of the secured creditor cramdown provision] is *not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan (Emphasis in the original)," … and adding, "[m]oreover … the value of a creditor's allowed claim does not include any degree of profit. There is no reason, therefore, that the interest rate should account for profit."[43]

Thus, the Bankruptcy Court concluded that the cramdown interest rate "should not contain any profit or cost element, which were rejected by *Till* and the Second Circuit in *Valenti* as inconsistent with the present-value approach for cramdown purposes."[44] Rather, according to the Bankruptcy Court, the proper approach is to "[take] the profit out, [take] the fees out, and [compensate] the creditor under a formula starting with a base rate that is essentially riskless, plus up to a 1 to 3 percent additional risk premium, if any, at least as against the prime rate, for the debtor's own unique risks in completing its plan payments coming out of bankruptcy."[45] On that basis, the Bankruptcy Court also rejected the use of the rates provided in the committed exit and bridge facilities, holding that those rates had a built-in profit element, which could not

[39] *Id.* at 25, 26.

[40] *Id.* at 26 (citing *Till* at 479 and *Valenti* at 64).

[41] *Id.*

[42] *Id.* at 25 (citing *Valenti* at 63-64).

[43] *Id.*

[44] *Id.* at 26.

[45] *Id.* at 28. It should be noted that the Bankruptcy Court appears to have also adopted the Supreme Court's rejection of certain other market-based approaches, each of which, in the Supreme Court's words, are "complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value …." *Id.* at 25 (citing *Till* at 477).

readily be backed out, and therefore were inconsistent with the principles espoused in *Till* and *Valenti*.[46]

Finally, the Bankruptcy Court rejected the indenture trustees' suggestion that it should first consider whether an efficient market for exit financing exists, and then apply the formula approach only if such a market does not exist.[47] The Bankruptcy Court held that such a process generally "misinterprets" *Till* and *Valenti*, as well as the purpose of Section 1129(b)(2)(A)(i)(II) of the Bankruptcy Code and that would almost invariably lead to a "dead end,"[48] given that the secured creditor should merely be put into the same position it would have been in had it received the value of its claim immediately. The Bankruptcy Court reasoned:

> [T]he vast majority of cases have ultimately applied a *Till* prime-plus approach or base rate-plus approach to the chapter 11 cramdown rate, either having spent considerable time determining that there is no efficient market or simply by moving to the base-rate-plus formula in the first instance … *This should not be surprising because it is highly unlikely that there will ever be an efficient market that does not include a profit element, fees and costs, thereby violating Till and Valenti's first principles, since capturing profit, fees and costs is the marketplace lender's reason for being. That is … market lenders need to be rewarded, or … receive a profit*.[49]

- *Under the* Till *approach, the use of Treasury rates, plus a 1.5 percent and 2 percent risk premium is appropriate here, but the risk premium should be increased by an additional 0.5 percent and 0.75 percent, respectively*. After reviewing the evidence produced by the Debtors, the Bankruptcy Court concluded that the risk analysis conducted by the Debtors' experts was appropriate, and that the indenture trustees had not carried their burden to show why the Debtors' risk premiums were too low.[50]

  The Bankruptcy Court also held that it was appropriate for the Debtors to use Treasury rates instead of the prime rate as base rates given the tenor of the replacement notes (seven and seven and a half years, respectively), and the fact that those rates were truly riskless because the U.S. government is the obligor.[51] However, because the Treasury rates reflected lower risk than the prime rate used in *Till*, the Bankruptcy Court increased the risk premium by 0.5 percent for the first lien replacement notes and 0.75 percent for the 1.5 lien replacement notes and suggested that the plan be amended to reflected these adjustments:

  > I question whether the 1 to 3 percent risk premium spread over prime used in Till would be the same if instead, as here, a base rate equal to the Treasury were used. I say this in particular under the present circumstances where the prime rate for short-term loans is materially higher than the Treasury rate for long-term loans, a somewhat anomalous

[46] *See id.* at 29.

[47] *See id.* at 28.

[48] *Id.* (internal citations omitted).

[49] *Id.* (emphasis added).

[50] *See id.* at 30, 31.

[51] *See id.* at 31. Conversely, according to the Bankruptcy Court, the prime rate contains an inherent element of risk given that it correlates to the rate banks charge each other on overnight interbank loans and thus may reflect risks in the banks' financial strength. *Id.*

> result. It seems to me, then, that although the general risk factor analysis conducted by [the Debtors' witness] was appropriate, there should be an additional amount added to the risk premium in light of the fact that the debtors used Treasury rates as the base rate. *The additional increment, I believe, should be another .5 percent for the first lien replacement notes, and an additional .75 percent for the 1.5 lien replacement notes. I believe that these adjustments adequately take into account risks inherent in the debtors' performance of the replacement notes above the essentially risk-free Treasury note base rates.*[52]

The resulting effective rates, as adjusted, were 4.1 percent for the first lien replacement notes and 4.85 percent for the 1.5 lien replacement notes.[53] Notably, the Bankruptcy Court did not explain its methodology for arriving at the 0.5 percent and 0.75 percent adjustments nor how it had determined that such adjustments accounted for the risk spread between Treasury and prime rates.

Implications

The practical effect of the Bankruptcy Court's decision was the involuntary transfer of value from the senior secured lenders to more junior classes who arguably received value not bargained for pre-bankruptcy and which transfer would not have otherwise occurred in a consensual lending market. The ruling has been appealed by the indenture trustees for both the first and the 1.5 lien holders. If upheld or endorsed by other courts, the decision could have far-reaching implications for distressed and non-distressed borrowers and other market participants as lenders seek to protect themselves against the prospect of Chapter 11 cramdown of this type.

Secured lenders, believing that they might be compelled under a Chapter 11 plan to accept takeback paper at below-market rates or at rates that otherwise yield lower-than-expected returns, or believing that they have lost the leverage that they have historically enjoyed in Chapter 11 negotiations over plan terms or proposed exit strategies, could charge higher fees or impose other costs on borrowers to compensate for those increased risks. They could also try to negotiate concessions from junior creditors in intercreditor arrangements, such as enhanced turnover provisions. In addition, distressed borrowers may have more difficulty attracting new financing in light of lender concerns that regardless of the terms that are negotiated pre-bankruptcy, those terms could be substantially modified (as to maturity, interest rate and other terms) without their consent under the cramdown provisions of the Bankruptcy Code. Further, other market participants (principally competitors) will likely argue that the decision artificially subsidizes debtors emerging from bankruptcy by allowing them to obtain financing at rates not otherwise available in the market.

Finally, this ruling could also impact the trading market for distressed debt. If upheld, the ruling could have an adverse impact on the market value of distressed secured debt as purchasers seek to discount price based on the increased risk associated with possible cramdown.

Authored by Adam C. Harris (+1 212.756.2253 | adam.harris@srz.com) and Karen S. Park (+1 212.756.2036 | karen.park@srz.com).

[52] *Id.* at 32 (emphasis added).

[53] *Id.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication Volume 31, Number 7 • May 2014

Credit Bid Buyers Beware: Delaware Bankruptcy Court Caps Credit Bid

By Adam C. Harris, David M. Hillman and James T. Bentley

On Jan. 10, 2014, the United States Bankruptcy Court for the District of Delaware (the bankruptcy court) in *In re Fisker Automotive Holdings, Inc., et al.*, capped a secured creditor's right to credit bid its $168 million claim at only $25 million (the amount it paid to purchase the claim). The secured creditor immediately appealed to the district court. As a procedural matter, the secured creditor had an absolute right to have its appeal heard only if the bankruptcy court's ruling was considered a "final order." If it was not a "final order," then the district court had discretion to hear the merits of the appeal. On Feb. 7, 2014, the district court determined that the bankruptcy court order was not final, and declined to hear the appeal. In doing so, however, the district court made sweeping statements regarding the bankruptcy court's authority to limit or otherwise deny a secured creditor the right to credit bid. Eleven days later, the bankruptcy court approved the sale of the debtors' assets to a third party. The secured creditor has since consented to the sale and withdrawn its appeal.

While the bankruptcy court has stated that its decision is non-precedential, it serves as a cautionary tale for secured lenders who may want to credit bid to acquire a debtor's assets.

Facts

Fisker Automotive Holdings, Inc. and Fisker Automotive, Inc. (collectively, Fisker) developed and sold luxury plug-in hybrid electric cars. To finance its business, Fisker obtained a $530 million loan commitment (the Loan) from the Department of Energy (DOE). The Loan was secured by liens on substantially all of Fisker's assets. Fisker defaulted under the Loan and, in 2012, retained an investment banker to explore strategic alternatives and a potential sale, which efforts were unsuccessful.

The DOE decided to sell the Loan in the secondary market, and hired a nationally recognized financial adviser to run an auction sale process. In October 2013, after extensive marketing efforts, five bids were submitted, including one by Wanxiang America Corporation (Wanxiang) and another by Hybrid Tech Holdings, Inc. (Hybrid), a Fisker affiliate. Hybrid was the successful bidder at the auction, purchasing the Loan for $25 million. At the time of the sale, there was $168 million in principal amount outstanding under the Loan.

Fisker filed for Chapter 11 relief on Nov. 22, 2013. It immediately sought approval of a private sale of its assets to Hybrid and approval of debtor-in-possession financing (the DIP Loan) from Hybrid. The sale motion sought authority to sell Fisker's assets to Hybrid, without further marketing or an auction, for: 1) $75 million in the form of a credit bid of a portion of the Loan; 2) a waiver of a portion of the DIP Loan; 3) the assumption by Hybrid of certain liabilities; and 4) certain cash payments, a portion of which (approximately $500,000) would be left behind for unsecured creditors. Fisker also filed a plan of liquidation to address the administration of the remainder of its assets.

The creditors' committee (the Committee) was appointed in December 2013, and began litigating with Hybrid on several fronts. The Committee objected to Fisker's sale to Hybrid, arguing, among other things, that Hybrid should not be allowed to credit bid because: 1) Wanxiang, which had lost the auction for the Loan, had made a superior unsolicited offer for Fisker's assets, 2) denying Hybrid the right to credit bid would foster a competitive bidding environment, and 3) there was a dispute as to the validity of Hybrid's liens on a portion of its collateral. The Committee asserted that that the existence of a dispute regarding the validity of Hybrid's liens on a portion of its collateral constituted "cause" to prevent Hybrid from credit bidding. To justify its alternative argument to cap Hybrid's credit bid, the Committee introduced expert testimony that concluded, among other things, that the $25 million Hybrid paid for the Loan reflected a fair, reasonable and market-tested valuation of the collateral. The Committee also sought standing to commence an adversary proceeding against Hybrid seeking to equitably subordinate its secured claim asserting that Hybrid, an insider, should be precluded from credit bidding because its principals had engaged in self-dealing and breached fiduciary duties owed to Fisker.

On Jan. 10, the bankruptcy court held a hearing to consider the Committee's objection. At the hearing, the Committee and Fisker agreed to limit the issue before the bankruptcy court to a determination of whether Hybrid could credit bid its secured claim and, if so, whether "cause" existed to cap Hybrid's right to credit bid.

Bankruptcy Court's Ruling: Credit Bid Capped at $25 Million

After hearing the parties, the bankruptcy court ordered (in an oral ruling from the bench) that "there ought to be an auction and that the only way for there to be an auction was to … place a cap on the credit bidding." *See* Transcript of Jan. 10, 2014 Hearing 136:22-25. The bankruptcy court supplemented its bench ruling on Jan. 17 with a written decision.

The bankruptcy court began its analysis with the text of Section 363(k) of the Bankruptcy Code, which provides that "unless the court *for cause* orders otherwise," a secured creditor may credit bid (*i.e.*, offset its secured claim against the purchase price) in a sale of its collateral. 11 U.S.C. § 363(k) (emphasis added). The bankruptcy court concluded that "cause" existed to limit the credit bid because, among other things: 1) absent a cap on Hybrid's credit bid, Wanxiang would withdraw its bid and refuse to participate in the auction; and 2) the extent of Hybrid's liens on some of its collateral had not yet been determined. In support of its ruling, the Bankruptcy Court cited the Third Circuit's *Philadelphia Newspapers* decision where, in a footnote, the Third Circuit stated 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."

Adam C. Harris and **David M. Hillman** are partners in the New York office of Schulte Roth & Zabel LLP, where Mr. Harris is chair of the Business Reorganization Group and a member of the firm's Executive Committee. Mr. Hillman practices in the areas of corporate restructuring and creditors' rights litigation. **James T. Bentley** is a special counsel in the same office, where he represents financial institutions, private equity firms, multi-employer benefit funds and others in reorganizations and out-of-court workouts.

Philadelphia Newspapers, 599 F.3d 298, 315-16 fn. 14 (3d Cir. 2010) (affirmed the denial of a right to credit bid for a sale of assets under plan, as opposed to a sale under section 363).

The bankruptcy court left open the possibility that the cap on Hybrid's credit bid could be modified after the bankruptcy court determined how much of Hybrid's claim would be allowed as a secured claim.

Hybrid's Appeals to the District Court

Hybrid sought leave to appeal to the extent the bankruptcy court's credit bid order was deemed interlocutory (*i.e.*, not final) and for certification for direct appeal to the Third Circuit. Hybrid argued that the bankruptcy court's decision to cap its right to credit bid in order to encourage competitive bidding was inconsistent with controlling Third Circuit and U.S. Supreme Court precedent, citing *SubMicron Sys. Corp.*,432 F.3d 449, 459 (3d Cir. 2006) and *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) for the proposition that a secured creditor had a right to credit bid the full amount of its claim. According to Hybrid, the bankruptcy court's reliance on the Third Circuit's *Philadelphia Newspapers* decision was flawed because two of the three judges in that case declined to adopt the portion of the opinion with the footnote the bankruptcy court had relied upon. Thus, Hybrid asserted the premise that a court can limit a credit bid to foster competitive bidding was mere *dicta*. In any event, Hybrid contended that the *Philadelphia Newspaper*s decision was later overruled by the United States Supreme Court in *RadLAX*.

Hybrid also argued that only its lien on a portion of the collateral was in dispute. Thus, its right to credit bid for collateral that was indisputably secured by its liens could not be limited merely because the Committee disputed Hybrid's lien on other portions of the collateral. In sum, Hybrid argued it had the right to credit bid the full amount of its claim for those assets as to which there was no dispute as to the validity of its liens. Hybrid contended that because its appeal involved the auction process itself and the preservation of its rights as a secured creditor, it would be left without a remedy if it were not permitted to credit bid at the auction.

The District Court's Decisions

On Feb. 7, 2014, the district court determined that the bankruptcy court order was not final and declined to hear the appeal. The district court found that there was no "controlling question of law as to which there exists substantial grounds for a difference of opinion" because the bankruptcy court's ruling was supported by the "plain text of 363(k)," which permits a bankruptcy court to limit credit bidding for "cause," and "relevant legal precedent." The district court effectively adopted the bankruptcy court's rationale that "cause" to cap a credit bid incudes fostering a competitive bidding environment.

The district court also dismissed Hybrid's argument that it would be without a remedy if the auction occurred while its credit bid was capped at $25 million. The district court noted that Hybrid could credit bid $25 million and continue bidding with cash. In that context, Hybrid could effectively "round-trip" the cash component to the extent of its allowed secured claim about $25 million. If a third-party bidder won the auction, Hybrid would receive its entitlement from the sale proceeds.

Five days later, on Feb. 12, the district court issued a second opinion denying Hybrid's motion for a direct appeal to the Third Circuit. Further addressing the merits of Hybrid's argument, the district court held that the "for cause" exception of 363(k) was within a bankruptcy court's discretion. The district court also disputed Hybrid's assertion that the "for cause" exception set forth in the *Philadelphia Newspapers* decision was mere *dicta*, stating that it was, in fact, "essential to its holding and was a majority ruling."

The Auction

After an 18-round auction that lasted two days, Wanxiang was selected as the winner with a $149.2 million bid. Hybrid stated shortly after the auction that it would not seek further review of the bankruptcy court's credit bid decision and did not object to the selection of Wanxiang as the highest bid pursuant to the bankruptcy court's bidding procedures. Hybrid did reserve its rights with respect to a number of disputes, including the allocation of the sale proceeds. On Feb. 18, the bankruptcy court approved the sale to Wanxiang.

Observations

Even though the decision is supposedly non-precedential, secured creditors should be concerned about this decision because it could be used as a litigation tactic by committees and other parties in interest to deprive a secured creditor of its right to credit bid by disputing the validity or enforceability of all or any portion of the creditor's lien (especially in fast-moving cases). Secured creditors should work with counsel early in a bankruptcy case (even before a debtor files) to consider creative and practical solutions to these potential attacks, such as: 1) providing debtor in possession financing to obtain a lien on unencumbered assets or assets that are subject to dispute as to the validity of the creditor's prepetition liens; 2) developing an expedited process to resolve simple lien disputes; and 3) using non-credit bid currency to acquire unencumbered assets, such as cash or the assumption of prepetition liabilities.

This decision may have a chilling effect on future secured claim auctions and could have broader implications for the claims trading markets generally. This effect will be especially felt by strategic buyers who acquire secured debt with a view toward using that debt as acquisition currency in so-called "loan to own" strategies. Compounding this effect is a small but relevant body of case law in which courts have designated a secured creditor's votes on a plan of reorganization when the creditor is found to have purchased the debt to obtain control of the debtor or to gain a competitive advantage. *See, e.g., In re DBSD N. Am., Inc.*, 421 B.R. 133, 141-142 (Bankr. S.D.N.Y. 2009) (designating vote of secured creditor who had purchased debt as means of advancing its "strategic investment interests wholly apart from maximizing recoveries" on its claims) (aff'd *Dish Network Corp. v. DBSD N. Am., Inc.* (*In re DBSD N. Am., Inc.*), 627 F.3d 496 (2d Cir. 2010). This decision also may give pause to any purchaser of secured claims who intends to credit bid, who could fear that their claims would be valued at what they paid for them rather than the face amount of the claim.

The court's reliance on the footnote from the *Philadelphia Newspapers* decision appears to be results-oriented. While fostering "a competitive bidding environment" may be a legitimate policy objective, capping a credit bid also tramples the important policy objective of protecting a secured creditor's property interest. One of the chief protections afforded to a secured creditor is the statutory right to credit bid. As stated by the Supreme Court, "the ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan." *RadLAX*, 132 S. Ct. at 2070 n.2.

Because Hybrid will not prosecute its appeal of the bankruptcy court decision, the issue of what constitutes "cause" to cap or eliminate a credit bid will continue to be hotly contested.

Schulte Roth&Zabel

Alert

ABI Commission Report: Highlights of Proposed Chapter 11 Reforms

December 8, 2014

The American Bankruptcy Institute ("ABI") Commission to Study the Reform of Chapter 11 issued today a 400-page report (the "Report") recommending changes to Chapter 11 of the Bankruptcy Code ("Code"). The Report is the result of a two-year effort by 150 practitioner-ABI members.[1] Without considering the likelihood of Congressional passage in the near term, we will evaluate each significant proposed change separately in subsequent *Alerts* over the next several weeks. This *Alert* includes a non-exhaustive list of the ABI recommendations that, if enacted, would most affect our clients involved with DIP lending and Section 363 sales.

DIP Loans

- No "roll-ups" (i.e., using DIP loan proceeds to pay down, in whole or in part, prepetition secured claims) unless: (1) the DIP facility is provided by new lenders who do not hold the prepetition debt that will be paid down; or (2) the DIP lender extends "substantial new cash" and provides "more financing on better terms than alternative facilities offered to the debtor" (Report, at 73); and if roll-up is permitted, it cannot be effectuated until the final financing order. (Report, at 80).
- No DIP lien or DIP claim on avoidance actions or proceeds. (Report, at 73).
- No case "milestones, benchmarks, [or] similar provisions" during the first 60 days (e.g., deadlines to conduct a sale, obtain entry of an order approving bid procedures or obtain approval of plan support agreement). (Report, at 73).
- No waiver of Section 506(c), which allows a DIP/trustee to surcharge a lender's collateral. (Report, at 226).
- No waiver of Section 552(b), which allows the court to "limit or terminate" a "creditor's prepetition lien on postpetition property of the estate." (Report, at 230).
- No lien or claim acknowledgements in interim financing order. (Report, at 80).

Section 363 Sale of "Substantially All Assets"

- No sale of substantially all of debtor's assets in first 60 days of the case unless debtor can show "by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during the 60-day period." (Report, at 83).

[1] The Report is available on the ABI Commission's website at commission.abi.org.

- Out-of-the-money stakeholders (referred to as the "Immediately Junior Class") are entitled to a portion of sale proceeds on account of "the future possibilities" that the "junior class might have been in the money or received a greater recovery if the firm had been valued at a later date," which is referred to as the "Redemption Option Value." (Report, at 208). The Redemption Option Value attributable to Immediately Junior Class "should be the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price [which equals 'the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor'] and a duration equal to three years after the petition date." (Report, at 219). The Redemption Option Value would be valued "using a market-based method such as the Black-Scholes model … ." (Report, at 221). The "bottom line implications" of this rule would be that "where the senior class distribution" results in close to payment in full, the immediately junior class is likely to be entitled to some Redemption Option Value. On the other hand, where the senior class is deeply impaired," the Immediately Junior Class " is likely to be entitled to receive little or nothing." (Report, at 222).
- Creditors must be afforded "at least the same level of protection" in the sale process as they enjoy in the plan confirmation process. (Report, at 206). The court must find by a "preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements" (Report, at 201):
    - Sale must comply with all applicable provisions of the Code (comparable plan provision found in Section 1129(a)(1));
    - Proponent of the sale complies with applicable provisions of the Code (comparable plan provision found in Section 1129(a)(2));
    - Sale was proposed in good faith and not by any means forbidden by law (comparable plan provision found in Section 1129(a)(3));
    - All payments made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses must be approved by the court as reasonable (comparable plan provision found in Section 1129(a)(4)); and
    - Sale proceeds must be reserved by the debtor in an amount sufficient to pay all allowed administrative expenses through the sale closing date (comparable plan provision found in Section 1129(a)(9)(A)).
- "Potential chilling effect alone should not constitute cause" to cap or limit a credit bid. (Report, at 146).

Adequate Protection

- No lien or claim on avoidance action or proceeds. (Report, at 68).
- Adequate protection lien and claim to be determined based on the foreclosure value (as opposed to liquidation value or going-concern value). (Report, at 67).

Plan

- Eliminate requirement of at least one impaired accepting class. (Report, at 257).
- "Redemption Option Value" (discussed in context of Section 363 sale) applies in context of plan confirmation. (Report, at 207).
- Cram-down interest rate is linked to market. If no market is available, then court should apply an appropriate risk adjusted rate. (Report, at 234).
- No "class-skipping" gift plans. (Report, at 237).
- Set standard for non-consensual third-party releases (Report, at 252) and exculpatory provisions for parties participating in Chapter 11 cases. (Report, at 250).
- Imposes "one creditor, one vote" rule, which "aggregates all claims in a particular class held by an entity and its affiliates that are subject to common investment management." (Report, at 257).

Intercreditor Agreements

- No enforcement of waiver by a junior creditor of the right to propose a non-priming DIP loan. (Report, at 73).
- No waiver or assignment of junior creditor's plan voting rights. (Report, at 261).

Court-Appointed Valuation Expert

- "The court should be permitted to use a court-appointed expert and to rely on hearing testimony of court-appointed expert in addition to any expert offered by the parties to assist in determining valuation issues." (Report, at 180).

Authored by David M. Hillman (+1 212.756.2174 | david.hillman@srz.com) and Michael L. Cook (+1 212.756.2150 | michael.cook@srz.com).

If you have any questions concerning this *Alert*, please contact the authors or one of the following Schulte Roth & Zabel attorneys: *Lawrence V. Gelber (+1 212.756.2460 | lawrence.gelber@srz.com), Adam C. Harris (+1 212.756.2253 | adam.harris@srz.com), David J. Karp (+1 212.756.2175 | david.karp@srz.com) or Brian D. Pfeiffer (+1 212.756.2157 | brian.pfeiffer@srz.com)*.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

Schulte Roth & Zabel

Alert

Priming DIPs: The New Normal?

December 22, 2014

Following the Dec. 8 publication by the American Bankruptcy Institute ("ABI") Commission to Study the Reform of Chapter 11 of a report (the "Report") recommending changes to Chapter 11 of the Bankruptcy Code ("Code"),[1] we continue to analyze the proposals contained in the ABI's 400-page Report. One proposal we wanted to immediately highlight would, if adopted, significantly increase the risk profile for secured lenders. By proposing a change to the currently accepted meaning of "adequate protection," the Report would make it materially easier for debtors to obtain DIP financing secured by a lien that would prime an existing first lien lender ("Priming DIP Loan") and to use the lender's "cash collateral" without consent.

Current Law

In the context of a Priming DIP Loan, "adequate protection" is intended to protect an existing secured creditor against any erosion of collateral value resulting from: (1) a new Priming DIP Loan subordinating the lien and claim of an existing secured creditor; or (2) the debtor's use of cash collateral. As Congress explained, the purpose of the adequate protection requirement is to ensure that secured creditors are not "deprived of the benefit of their bargain." *See* H.R. Rep. No. 95-595 (1977). The Code does not define adequate protection, but Section 361(e) of the Code provides three nonexclusive means of providing adequate protection: (1) periodic cash payments to the extent of any decrease in collateral value; (2) an additional or replacement lien to the extent of any decrease in collateral value; or (3) any other relief that will result in the secured lender's receiving the "indubitable equivalent" of its interest in the collateral. In sum, adequate protection, regardless of its form, "should as nearly as possible under the circumstances of the case provide the creditor with the value of his bargained for rights. … In other words, the proposal should provide the pre-petition secured creditor with the same level of protection it would have had if there had not been post-petition superpriority financing." *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 564 (3d Cir. 1994) (en banc) (internal quotations omitted).

To support a proposed Priming DIP Loan, debtors typically argue that the secured creditor is adequately protected against any erosion of its collateral value by the existence of an "equity cushion" — the amount by which the collateral value exceeds the amount of the primed secured claim. *See In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010) ("The exist[ence] 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) ("[T]he existence of an equity cushion can be sufficient, in and of itself, to constitute

[1] *See* our Dec. 8 *Alert*, "ABI Commission Report: Highlights of Proposed Chapter 11 Reforms, " available at www.srz.com/ABI_Commission_Report_Highlights_of_Proposed_Chapter_11_Reforms.

adequate protection."). The equity cushion is generally expressed as a percentage of the secured debt to be primed. For example, if the secured claim is $100 million and the collateral is worth $150 million, the equity cushion is 50 percent. Collateral valuation is at the heart of the bankruptcy court's determination of whether there is a sufficient equity cushion. There is no bright-line test for the size of the equity cushion, but courts have generally held a roughly 20-percent cushion (after giving effect to the incurrence of the Priming DIP Loan) to be sufficient, and anything below 10 percent to be insufficient.[2]

When, as is common, a secured creditor has a blanket lien on the debtor's assets, the valuation of its collateral will require a valuation of the entire business.[3] The valuation of a debtor "with an assembled workforce and operating business" should be on a going-concern basis. *See* Report, at 71; *In re Residential Capital LLC*, 501 B.R. 549, 591-95 (Bankr. S.D.N.Y. 2013) (finding that going-concern valuation of the debtor for adequate protection purposes was proper when the debtor's stated purpose in the case was to sell the properties as a going concern and the parties-in-interest never contemplated that creditors might conduct a foreclosure sale). The use of a going-concern valuation in the context of an operating debtor is logical and consistent with Section 506(a) of the Bankruptcy Code, which provides that when valuing collateral, the appropriate valuation method turns on "the purpose of the valuation and of the proposed disposition or use" of the collateral. Applying the going concern approach (for an operating business) is also consistent with U.S. Supreme Court precedent holding that "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question." *See In re Rash*, 520 U.S. 953, 962 (1997).

Proposal

According to the Report, however, the use of a going-concern valuation for purposes of determining adequate protection may have the effect of "reducing significantly the debtor's financing and reorganization options." (Report, at 71). To enhance the debtor's postpetition financing options, "the Commission agreed that, for purposes of determining adequate protection under section 361, a secured creditor's interest in the debtor's property should be determined based on the 'foreclosure value' of such interest, instead of the more commonly used valuation standards such as liquidation value and going concern value." (Report, at 71). As the Report explains, "foreclosure value" means 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. … In the case of a foreclosure sale in which the secured creditor would acquire the collateral through a credit bid, the foreclosure value should be based on the net cash value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale, and not on the face amount of the debt used to acquire the property through the credit bid." (Report, at 67).

The practical consequences of the proposed changes are significant. Tying a secured lender's right to adequate protection to the foreclosure value of the collateral will make it materially easier for debtors to obtain court approval of Priming DIP Loans or the non-consensual use of cash collateral. So long as

---

[2] *See In re James River Assocs.*, 148 B.R. 790, 796 (E.D. Va. 1992) ("Case law has almost uniformly held that an equity cushion of 20% or more constitutes adequate protection … . Case law has almost as uniformly held that an equity cushion under 11% is insufficient to constitute adequate protection … . Case law is divided on whether a cushion of 12% to 20% constitutes adequate protection … ."); *In re McKillips*, 81 B.R. 454, 458 (Bankr. N.D. Ill. 1987) (same).

[3] According to a survey cited in the Report, "97 percent of prepetition financing facilities are secured by liens akin to blanket liens." (Report, at 70 n.280).

the going-concern value of the debtor's business (which could ultimately be realized in a later 363 sale or in connection with a reorganization plan) is high enough to create a sufficient equity cushion in excess of the collateral's foreclosure value, a debtor can obtain court approval of a Priming DIP Loan.

The following hypothetical illustrates the problem. Suppose a secured creditor holds a $100-million claim secured by a blanket lien on all assets, and the debtor seeks approval of a Priming DIP Loan in the amount of $20 million. Assume further that the secured creditor's collateral (i.e., the debtor's business) has a going-concern value of $130 million and a foreclosure value of $60 million. The equity cushion analysis under current law and under the Report's proposal are dramatically different:

- Under the current law, the Priming DIP Loan would likely be ***denied*** because the equity cushion is only 10 percent. The equity cushion is calculated as follows: $130 million going-concern value of business *less*: (1) $20 million proposed Priming DIP Loan; and *less* (2) *$100 million (full amount of secured claim that could be realized in a going-concern sale)*, leaving an equity cushion of $10 million (or 10 percent of the primed secured debt).
- Under the Report's proposal, the equity cushion would increase to more than 83 percent, and the Priming DIP Loan would easily be ***approved*** by the court. The equity cushion, using collateral foreclosure value, is calculated as follows: $130 million going-concern value *less*: (1) $20 million proposed Priming DIP Loan; and *less* (2) *$60 million (foreclosure value of collateral)*, leaving an equity cushion of $50 million to protect and preserve $60 million of foreclosure value (or approximately 83 percent of the foreclosure value).

The Report further provides that if the debtor relies on the equity cushion to provide adequate protection, the court should provide "further assurance" to the secured creditor by enabling it to compel the debtor to sell the collateral in a Section 363 sale if the "reorganization fails" or if there is "cause" to lift the automatic stay. (Report, at 72). This "additional assurance" to force a sale if the "reorganization fails" is not fully developed in the Report. Notably, however, the "additional assurance" of a forced sale might well be illusory (at least in the context of a Priming DIP Loan) because the primed secured creditor's recovery on its collateral will likely have been impaired after taking into account the failure of the debtor's reorganization efforts and the prior payment of the Priming DIP Loan.

The change in how adequate protection is applied will enable debtors to incur additional secured debt at the outset of the bankruptcy case without the consent of the prepetition secured creditor at a time when the exit plan is far from certain. At the end of the case, the secured creditor will be entitled to have the allowed amount of its secured claim determined by using the "reorganization value" of the collateral, as opposed to its foreclosure value. *See* Report, at 67; 11 U.S.C. § 506(a). However, the combination of the Priming DIP Loan and the allowed amount of the prepetition secured lender's claim is likely to exceed the debt capacity of the reorganized entity, or, at a minimum, make it highly unlikely that both could be refinanced through one or more exit facilities.[4] Thus, prepetition secured lenders who become subordinated to a Priming DIP Loan are more likely to find themselves being forced to accept riskier junior securities (e.g., subordinated secured or unsecured debt or equity) under a plan. Additionally, if the restructuring fails, prepetition secured lenders will have effectively financed the option (for the benefit of the lower ranking stakeholders) of achieving a successful restructuring if a

[4] Using the example above, the debtor would need to refinance $120 million of secured debt ($20-million Priming DIP Loan and $100-million prepetition secured debt) as against an entity with a going-concern value of $130 million.

subsequent sale of the debtor's assets fails to yield sufficient proceeds to fully satisfy the Priming DIP Loan and the prepetition secured debt.

Conclusion

The Report's proposed change to the adequate protection requirement would significantly impair the recoveries of secured creditors and create greater risks, and it represents a dramatic departure from existing law. The proposed change is subtle in appearance, but draconian in effect, especially for those lenders with blanket liens or who otherwise rely on the borrower's future cash flows as the primary source of repayment.

Authored by Michael L. Cook (+1 212.756.2150 | michael.cook@srz.com), Adam C. Harris (+1 212.756.2253 | adam.harris@srz.com), David M. Hillman (+1 212.756.2174 | david.hillman@srz.com), Lawrence V. Gelber (+1 212.756.2460 | lawrence.gelber@srz.com) and Brian C. Tong (+1 212.756.2159 | brian.tong@srz.com).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel

Alert

ABI Commission Report Recommendations on DIP Financing Would Eliminate Lender Protection

December 30, 2014

The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the "Commission") issued its 400-page *Final Report and Recommendations* (the "Report") on Dec. 8, 2014. The Report recommends a variety of changes to Chapter 11 of the Bankruptcy Code. In this *Alert*, we discuss the Report's recommendations on debtor-in-possession ("DIP") financing, which, if enacted, could have a significant impact on both prepetition secured lenders and DIP lenders.[1]

Background on DIP Financing

Many Chapter 11 debtors require DIP financing to operate in bankruptcy. DIP lenders — who often are also the debtor's prepetition secured lenders — traditionally receive certain inducements, concessions and protections in exchange for making these postpetition loans. For example, prepetition lenders who offer DIP financing often seek:

- Concessions regarding: (1) the validity or enforceability of prepetition liens; and (2) the amount of the lender's prepetition claims;[2]
- Inclusion of deadlines to achieve case milestones (e.g., deadlines for the sale of the business or the filing of a disclosure statement and plan);
- The ability to convert prepetition secured debt into DIP financing through a so-called "roll-up";
- Liens on avoidance actions and their proceeds; and
- Waivers of certain of the debtor's rights against the lender's collateral under the Bankruptcy Code.[3]

These concessions and protections can set the tone for the entire Chapter 11 case. The Commission apparently believes that the pervasive use by DIP lenders of these provisions has tipped the Chapter 11

[1] For additional discussions of the Report's recommendations with respect to adequate protection, see our Dec. 22, 2014 *Alert*, "Priming DIPs: The New Normal?," available at www.srz.com/Priming_DIPs_The_New_Normal, and be on the lookout for our forthcoming publications on cross-collateralization restrictions and intercreditor agreements (including the Report's recommendation to override certain provisions in intercreditor agreements restricting a junior secured creditor's ability to provide DIP financing).

[2] This is particularly so where there could be a dispute about the amount of the lender's prepetition claim, such as when the lender asserts that it is entitled to a make-whole or prepayment premium.

[3] Report, at 80.

scales too far in favor of DIP lenders and has recommended several ways to scale back or eliminate many of these protections.

Limitations on Interim DIP Orders

Debtors and lenders often seek interim approval of DIP financing from the bankruptcy court within the first few days of the case, with final approval following several weeks later.[4] The Commission was particularly concerned about debtors acceding on an interim basis to DIP lender demands for what the Commission deems "permissible extraordinary financing provisions," including requiring: (1) the debtor to perform milestones, benchmarks or other tasks (described further in "No Case Milestones in the First 60 Days," below); (2) that the debtor make representations regarding the validity and extent of a creditor's liens on the debtor's property; and (3) that the DIP lender's prepetition secured debt be rolled up into the postpetition facility (described further in "Limitations on Roll-Ups of Prepetition Debt," below). The Commission stated that the danger in permitting such "permissible extraordinary financing provisions" in interim financing orders is that parties-in-interest "may not have sufficient time or information to accurately assess the import of such provisions and the impact they may have on the case."[5]

Thus, the Report recommends that bankruptcy courts should not approve these "permissible extraordinary financing provisions" in an interim order.[6] This recommendation is particularly troubling for secured lenders who are asked at the outset of a case to immediately consent to the use of their cash collateral and/or to provide additional financing. For example, secured lenders often seek agreement with a debtor early in the case on the validity of their prepetition liens and the amount of their prepetition claims to ensure that a debtor will not use the lender's own cash collateral or proceeds of a DIP loan to litigate with the lender over those matters.[7]

If enacted, these recommendations could increase the risk profile for DIP lending because these lender protections will not be available upon entry of an interim order when initial advances are made to the debtor. In other words, the protections would not be available until entry of a final order — long after the DIP loan has already been made. To counter this loss of protection, prospective DIP lenders may well seek additional, or other, protections such as higher interest rates to compensate them for the uncertainty and the litigation risk they may face on their prepetition claims.

No Case Milestones in the First 60 Days

DIP lenders sometimes will insist that a debtor agree to establish case milestones to ensure that the debtor remains focused on implementation of its exit strategy. Milestones encourage a debtor to exit bankruptcy quickly to avoid the substantial administrative costs associated with an extended stay in Chapter 11, as well as to minimize the impact of the negative perception of bankruptcy to customers,

---

[4] 11 U.S.C. § 364(d). Under Federal Rule of Bankruptcy Procedure 4001(c), a final hearing on a motion to obtain postpetition financing requires at least 14 days' notice. Thus, debtors generally seek entry of an interim financing order at the "first day hearings," after which a portion of the financing may be provided, and a final financing order, which may include incremental amounts of financing at least 14 days after the motion is filed, by which time the committee of unsecured creditors usually has been appointed and has had time to analyze the proposed financing.

[5] Report, at 81.

[6] Report, at 80.

[7] Note that while a debtor's stipulations are typically binding on the debtor when the interim financing order is entered by the bankruptcy court, the creditor's committee and other parties-in-interest are given time to object to the lender's claims and liens before the stipulations become binding on them as well.

suppliers and other essential constituents. In recent years, more sales have been conducted and plans filed and/or confirmed in the very early stages of Chapter 11 cases as the use of milestones has become more prevalent.

Nevertheless, the Commission recommends that no DIP financing should be approved that "is subject to milestones, benchmarks, or other provisions that require the trustee [or debtor] to perform certain tasks or satisfy certain conditions within 60 days after the petition date or date of the order for relief."[8] The Report defines "milestones, benchmarks, or other provisions" as those that "relate in a material or significant way to the debtor's operations" during its bankruptcy case, including deadlines for conducting an auction, closing a sale,[9] or filing a disclosure statement and plan.[10]

The Commission believes that by limiting these milestones in the first two months of the case, the debtor will have more time to conduct robust auctions, explore restructuring alternatives, take advantage of market changes that could lead to better financing terms, and wait out cyclical or seasonal changes in the debtor's business.[11] While it is possible that longer stays in Chapter 11 might achieve some of these objectives, it is also possible that implementation of the proposed 60-day moratorium on milestones in DIP financings could have the opposite effect. Longer Chapter 11 cases may result in lower enterprise values; increased administrative expenses (particularly for professionals) that generally must be paid in full under a plan of reorganization; additional uncertainty on the part of vendors, suppliers and customers; and increased DIP financing costs. Thus, rather than enhancing the estate's prospects and creditor recoveries through robust processes that seek the highest bidders and lowest financing, the Commission's proposed change may decrease the value of the debtor's business, make DIP financing harder to obtain (which could result in more liquidations rather than reorganizations or going-concern sales) and ultimately reduce recoveries for creditors.

Limitations on Roll-Ups of Prepetition Debt

Prepetition lenders often seek to "roll-up" their prepetition debt in order to convert some or all of their prepetition secured debt into postpetition secured debt, which often enjoys additional protections and benefits (e.g., a more senior claim priority, a broader collateral base, etc.).[12]

The Commission sees a potential for abuse when a prepetition lender can improve its claim priority or obtain a larger collateral base, particularly if the putative DIP loan does not provide much new cash to the estate.[13] The Report thus recommends that no roll-up of prepetition debt into a DIP facility should

[8] Report, at 73, 79-80. The Report also recommends that the debtor put together a "valuation information package" ("VIP") that will include tax returns, annual financials, independent appraisals of the debtor's assets, and recent business plans or projections shared with prepetition existing or potential investors. Report, at 45. The Report further recommends that any motion to approve DIP financing filed within 60 days after the petition should include a list of the information included in the VIP, and that parties-in-interest may request a copy of the VIP for a "proper purpose," which they can receive if they execute a confidentiality agreement and, in certain instances, agree to restrict their trading activity. *Id.*

[9] We will provide a more complete discussion of the Report's recommendations on sales in Chapter 11, including its recommendation that sales be prohibited in the first 60 days of the debtor's bankruptcy case except in certain circumstances, in a forthcoming *Alert*.

[10] Report, at 80. The Report clarifies that payment of scheduled loan amounts, loan covenants, reporting requirements and compliance with a budget would not be affected by its recommendation as long as such markers were not "disguised milestones or benchmarks."

[11] Report, at 87.

[12] While the Commission uses the term "roll-up" to refer to any situation in which proceeds of postpetition financing are used to pay off prepetition debt, bankruptcy practitioners generally view roll-ups as the use of DIP financing proceeds to repay the DIP lender's own prepetition debt.

[13] Report, at 77-78.

be permitted unless the bankruptcy court finds that the proposed DIP financing is in the best interests of the debtor's estate and:

- The DIP facility is provided by *new* lenders who do not directly or indirectly hold the prepetition debt that will be paid down; or
- The DIP lender "repays the prepetition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor."[14]

Further, if one or more of the DIP lenders is also a prepetition lender, and prepetition debt is being refinanced by or rolled up into the DIP facility, the roll-up cannot be effectuated until entry of the *final* financing order (rather than the *interim* order).[15]

While the Commission's stated goal is to make DIP financing more readily available to debtors, the proposed limitation on roll-ups could have the opposite effect for a debtor's prepetition lenders, who may wish to provide DIP financing to protect their prepetition investment. Absent the ability to roll-up their prepetition debt, prepetition secured lenders likely will view DIP lending as a less attractive opportunity.[16] Moreover, without the realistic opportunity to provide future DIP financing, lenders may make prepetition financing more expensive for borrowers. Neither result appears to be consistent with the Commission's objectives. While potential DIP lenders outside the existing capital structure may welcome certain of these changes, these lenders may be more interested in quickly realizing a return on their investment, rather than working to stabilize and optimize the debtor's operations on a long-term basis.

No DIP Liens or Claims on Avoidance Actions or Proceeds
DIP lenders often seek a lien on avoidance actions (e.g., preference and fraudulent conveyance actions) or proceeds thereof.[17] The Commission, however, believes that a DIP lender has other means to secure its DIP financing, and that avoidance actions and the proceeds thereof may be a principal source of returns for general unsecured creditors.[18]

Thus, the Commission recommends that a court should not approve DIP financing that grants a lien on or claim to the estate's avoidance actions or the proceeds of such actions.[19] Implementation of this proposal would remove from the reach of DIP lenders a potentially significant source of collateral, thus

---

[14] Report, at 73.

[15] Report, at 80.

[16] While the second prong of the above-mentioned test would still allow a prepetition lender to roll-up its debt into the DIP facility, it is unclear what constitutes "substantial new credit" or "better terms."

[17] Debtors are often receptive to granting liens on avoidance actions to lenders because a lender who will either provide exit financing under a plan or ultimately own the business through a credit bid will be less likely to actually sue the recipients of such preferences and fraudulent conveyances (who are usually the company's existing vendors and customers) than a Chapter 7 trustee or creditor's committee that has no incentive to keep vendors and customers happy.

[18] Report, at 78.

[19] Report, at 73. As discussed in "Priming DIPs: The New Normal?," available at www.srz.com/Priming_DIPs_The_New_Normal, the Commission's recommendations may allow liens on avoidance actions or proceeds as adequate protection for prepetition lenders where other methods of adequate protection have failed.

either reducing the appeal of providing DIP financing or requiring debtors to pay higher interest rates to compensate for the DIP lender's increased risk profile.

No Waivers of Certain of the Debtor's Rights Under the Bankruptcy Code
There are two waivers that prepetition lenders who offer DIP financing typically attempt to obtain from a lender:

- *Section 506(c) Waiver*. Under Section 506(c), the debtor can surcharge or recover from a prepetition secured lenders' collateral the "reasonable, necessary costs and expenses of preserving, or disposing of," such collateral, provided such expenses directly benefit the secured lenders or the collateral.[20]
- *Section 552(b) Equities of the Case Waiver*. As a general rule, Section 552(a) of the Bankruptcy Code invalidates after-acquired property clauses in prepetition security agreements after the petition date.[21] Section 552(b) of the Bankruptcy Code provides an exception to the general rule for liens attaching to proceeds of prepetition collateral (as well as certain types of rent). This exception to the general rule, however, has its own exception, which provides that a court may limit or even eliminate the secured lender's lien in proceeds under 552(b) "based on the equities of the case."[22]

Lenders often seek waivers of the debtor's rights under Sections 506(c) and 552(b) in the DIP documents. The Commission believes a debtor should not be permitted to waive either protection.[23]

DIP lenders generally provide a limited carve-out for payment of a debtor's professional expenses and certain administrative claims or unsecured claims in exchange for a waiver of the debtor's Section 506(c) right to surcharge the lender's prepetition collateral. The Commission, however, felt that the debtor often has little power to negotiate the carve-out and the waiver often affected other stakeholders as well.[24] The Commission also believes that debtors "should not be able to waive, or enter into any agreement affecting, a court's ability to limit or alter a secured creditor's interest in the debtor's or the estate's property based on the equities of the case under section 552(b) of the Bankruptcy Code."[25]

The Commission's recommendations to prohibit these waivers, when coupled with its other recommendations, would further erode prepetition lenders' incentives to provide DIP financing. Rather than foster a more robust market for DIP financing options for debtors, this has the potential to reduce the availability of DIP financing from prepetition lenders.

---

[20] Report, at 227. Such expenses may include expenses related to maintaining and preserving collateral, operating the business and, in some jurisdictions, even the debtor's attorney's fees.

[21] In concept, this is supposed to provide the debtor access to unencumbered cash with which to fund its case, thus improving its chances of a successful reorganization.

[22] "The principal purpose of the equities of the case exception is to prevent secured creditors from reaping unjust benefits from an increase in the value of collateral during a bankruptcy case resulting from the debtor's use of other assets of the estate, or from the investment of non-estate assets." *Toso v. Bank of Stockton* (*In re Toso*), 2007 WL 7540985, at *13 (B.A.P. 9th Cir. Jan. 10, 2007).

[23] Report, at 226, 230.

[24] Report, at 230.

[25] Report, at 230. The Commission also declined to adopt a federal definition of the term "proceeds," instead leaving that definition to state law.

Conclusion

The Commission's proposed changes regarding DIP financing collectively represent a dramatic departure from the protections currently afforded to lenders. Enactment of these proposals likely will make DIP financing less attractive to the debtor's prepetition lenders who may be the debtor's sole potential source of DIP financing. Further, the lack of "traditional" DIP protections could cause lenders to hesitate before lending to distressed companies or force those companies to provide other forms of protection, such as higher interest rates or more expansive make-whole provisions. Enactment could also lead to longer and more expensive cases, particularly if expedited sale or plan processes are no longer permitted, which could erode recoveries for junior and unsecured creditors.

While some of these changes, particularly when coupled with the Commission's recommendations concerning adequate protection, may make it easier for new lenders to provide DIP financing, such new DIP lenders may only be interested in opportunistically seeking returns and not providing meaningful opportunities for the reorganization of the debtor's business. Though the Commission's recommendations are likely to take several years to be implemented, if ever, lenders to distressed companies should be mindful of these potential changes in making their current credit decisions.

Authored by Lawrence V. Gelber (+1 212.756.2460 | lawrence.gelber@srz.com), James T. Bentley (+1 212.756.2273 | james.bentley@srz.com) and Lucy F. Kweskin (+1 212.756.2226 | lucy.kweskin@srz.com).

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel

Alert

"Redemption Option Value": Mandatory Distributions to Out-of-the-Money Stakeholders

February 5, 2015

On Dec. 8, 2014 the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the "Commission") issued its 2012-2014 Final Report and Recommendations (the "Report"), proposing numerous changes to Chapter 11 of the Bankruptcy Code ("Code"). This *Alert*, which is one of a series (available at www.srz.com/SRZ_Business_Reorganization_Attorneys_Produce_Series_on_ABI_Commission_Report/) published by Schulte Roth & Zabel LLP that analyzes the Report, focuses on the Commission's proposal to compel senior creditors to pay a mandatory "tax," or so-called "redemption option value" ("ROV"), to junior stakeholders. Simply put, this proposal, if enacted, would force senior creditors to give a portion of the value of their collateral to out-of-the-money stakeholders *even if* the senior creditors are *not* being paid in full. The proposal is a significant departure from fundamental bankruptcy principles, including the "absolute priority rule," and would in many cases impair the expected recoveries of secured creditors.

What Is the ROV Proposal Generally?

Senior creditors would be required to share a portion of their distributions from the debtor's estate, whether received under a plan or in connection with a sale of substantially all of the debtor's assets (referred to as a "Section 363x sale") with certain junior stakeholders, regardless of whether the senior creditors are paid in full. The amount senior creditors would be required to share would be based on the value of a hypothetical option to acquire the company within a reasonable period of time after the effective date of a Chapter 11 plan or a Section 363x sale order. Report, at 218. The proposal also includes certain elements designed to discourage junior stakeholders from litigating the value of the debtor's business. *See* Report, at 209.

How Is ROV Calculated?

ROV is intended to reflect the value of a "hypothetical option" to purchase the debtor's business at a future date. Report, at 209. As with traditional options, the key components of ROV are the strike price (referred to as the "redemption price") and the redemption period. *Id*. The redemption price equals the full face amount of the claims of the senior creditors, including any unsecured deficiency claim, interest at the non-default contract rate, and allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of the exercise of the redemption option, as though the senior creditors' claims remained outstanding on the date of exercise. Report, at 210. The redemption period is the period of time between the plan effective date (in the Chapter 11 plan context) or the date of the order approving the sale (in the Section 363x sale context) and the third anniversary of the petition date. Report, at 208. ROV would be determined through generally accepted market-based valuation models, including the Black-Scholes option pricing model. Report, at 210. In addition to the redemption price and redemption period, the Black-Scholes valuation would use a volatility rate appropriate for the particular debtor and a risk-free rate (generally based on the U.S. Treasury rate). Report, at 221. According to the Report, in a scenario "where the senior class is entitled to the entire value of the firm and is determined to be receiving 50 percent of the principal amount of their claims … the [ROV] likely holds no value for the [junior stakeholders] under reasonable assumptions." If, however, the "percentage recovery of the senior class [is changed] to 90 percent [and all other assumptions remain unchanged] … the [ROV] is approximately 5 percent of the reorganization value, which would be distributed to the [junior class]." Report, at 221-22.[1]

Who Benefits?
ROV is payable to the class of stakeholders immediately junior (the "immediately junior class" or "IJC") to the senior creditors benefiting from preservation of the debtor's going-concern value in a Chapter 11 plan or a Section 363x sale. Report, at 207-08. According to the Commission, the IJC "will typically be the class immediately junior to the fulcrum security class … ." Report, at 210.

Who Pays?
Generally speaking, the senior class(es) of creditors receiving either proceeds of a Section 363x sale or residual interests in the reorganized entity under a plan would, as a practical matter, be paying ROV to the IJC.[2] In the plan context (if the plan does not contemplate a sale), "the relevant senior stakeholders are the class or classes of senior creditors receiving the residual interests (e.g., equity securities) in the firm" but would not include "a senior class paid in cash or solely in debt securities of the reorganized firm." Report, at 208 n.762. On the other hand, the relevant senior class in the Section 363x sale context would be the class or classes entitled to receive the sale proceeds. *Id*. The senior class required to surrender value would be entitled to determine the form of consideration in which ROV is to be paid (i.e., cash, debt, stock, warrants or other consideration).[3] Report, at 210.

Is ROV Payable in the Chapter 11 Plan Context?
Yes. The proposal to require senior creditors to share a portion of their plan distributions with the IJC would be implemented through amendments to the cram-down provisions of Code Section 1129(b). Report, at 208. Critically, Section 1129(b) would be amended to provide that a plan may be confirmed over the rejection by a senior creditor class that "is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an [IJC] of the [ROV], if any, attributable to such class." Report, at 208-09.

[1] The "reorganization value" refers to the value of the debtor's business and is calculated differently in the plan context and the Section 363x sale context. In the plan context, reorganization value equals "the enterprise value attributable to the reorganized business entity, plus the net realizable value of [the reorganized entity's] assets that are not included in determining the enterprise value and are subject to subsequent disposition as provided in the confirmed plan." Report, at 207. In the context of a Section 363x sale, however, "reorganization value" equals "the net sale price for the enterprise plus the net realizable value of [the enterprise's] assets that are not included in [the] sale and are subject to subsequent disposition … as contemplated at the time of the sale." *Id.* These valuation methodologies do not appear inconsistent with existing law.

[2] The Commission states that "the estate … should be responsible for paying" ROV, but it also recognizes that "[o]f course, any such value paid from the estate will reduce the value available for the senior class." Report, at 224.

[3] Non-cash consideration would be valued on a basis consistent with the manner in which the reorganization value was determined. Report, at 210. Further, as a practical matter, in a sale of all or substantially all of the debtor's assets (whether in a Section 363x sale or under a plan), ROV would take the form of non-cash consideration only if the sale consideration were itself not cash.

With respect to a rejecting IJC,[4] a plan would be confirmable so long as the IJC receives not less than the ROV attributable to such class. Report, at 208. If, however, the IJC rejects the plan *and* "challenges the reorganization value used to determine [its] entitlement to [ROV]," a court could still confirm the plan if it finds that the reorganization value was not proposed in bad faith and the plan satisfies the cram-down provisions "other than the requirement that [ROV] be provided to such class." Report, at 209. In other words, the IJC would be entitled to ROV so long as it does not dispute the reorganization value that the plan proponent used to calculate ROV. *Id*.

Is ROV Payable in the Section 363x Sale Context?

Yes. ROV would be payable to the IJC in connection with a Section 363x sale. Unlike in the plan context, ROV would be payable even when the senior class is paid in cash and receives no "residual interest," or equity interest in the assets that are sold in the Section 363x sale. Report, at 208 n.762, 209. If, however, the IJC objects to the sale, it will not be entitled to ROV (the "Deathtrap Provision"). Report, at 209.

Is ROV Payable Even If a Senior Class Is Not Paid in Full?

Yes. The Commission proposes that the Code require an allocation of ROV to the IJC regardless of whether the relevant senior class has been paid in full. Report, at 208-09.

The Commission's Rationale

The Commission found that the absolute priority rule, while an "important creditor protection," can result in an allocation of value among creditors "in an arguably random manner depending on the timing of the value realization event — i.e., plan confirmation." Report, at 213. Similarly, in the context of a Section 363x sale, the Report states:

> Although the price being offered for a debtor's assets arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale, or economic or industry factors are negatively impacting valuations, the debtor's estate may be monetized at value far below what the estate could be worth at a later date to the prejudice of stakeholders lower in the pecking order of priorities.

Report, at 214.

According to the Commission, if the assets are valued "during a trough in the debtor's business cycle or the economy as a whole," and the proceeds are distributed solely to a senior class, there is an "arguable unfairness" to junior stakeholders who are then foreclosed from participating in any future appreciation of the value of the assets sold or going-concern value of the reorganized entity when the business cycle or economy improves. Report, at 207, 213. The Report therefore concludes that "relying on a valuation [during such a trough] may result in a reallocation of … future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code's principle of providing a breathing spell from business adversity." Report, at 207.

The proposed allocation of ROV to the IJC in a Section 363x sale or under a plan is intended to address this potential unfairness. That is, ROV recognizes that "the future possibilities of the ongoing firm include the possibility that the IJC might have been in the money or received a greater recovery if the

[4] To confirm a plan under existing law, a debtor must satisfy the cram-down provisions with respect to any class that does not vote to approve the plan, including any class that is not entitled to receive distributions under the plan.

firm had been valued at a later date." Report, at 208. The proposed distribution of ROV to the IJC thus reflects the possibility that during the redemption period, the value of the firm might increase and be sufficient not only to pay the senior creditors in full with interest, but also to provide incremental value to the IJC. *Id.*

Potential Impact on Secured Creditors
If enacted, the ROV recommendation would have a significant impact on secured creditors. First, the proposal would likely reduce secured creditor recoveries when compared to recoveries under existing law. By requiring secured creditors to pay ROV to an IJC, the proposal effectively imposes a tax on secured lenders.

The stated rationale for requiring the payment of ROV to the junior class, as discussed above, is to address some "arguable unfairness" to junior stakeholders who are unable to participate in any potential future appreciation if the assets are sold during a down cycle. But the proposal requires the senior class to pay ROV even in circumstances where the senior class is receiving cash proceeds from the sale of its collateral and has no right to share in the potential future appreciation of the assets. Payment of the ROV, especially in this context, is extraordinarily unfair and punitive.

Despite the deterrents built into the recommendation, the proposal seems likely to generate additional litigation over the determination and allocation of ROV (and its constituent parts). For example, in the plan context, the IJC would be foreclosed from receiving ROV if it "challenges the reorganization value used to determine [its] entitlement" to ROV. But reorganization value is only one component of ROV — the IJC could challenge the other aspects of ROV, such as the redemption price, redemption period or the methodology used to calculate ROV, and still preserve its right to payment of ROV. This additional litigation could increase the length of the sale or confirmation process and could also add (potentially significant) costs to the estate.

In addition to any delay caused by ROV-related litigation, the matter of determining the IJC may, in itself, add delay to the Section 363x sale approval process, including the distribution of sale proceeds to the senior class. Under the proposal, a sale approval order must provide "for an allocation of redemption option value to the immediately junior class." Report, at 209. Yet, in cases where there is uncertainty as to the amount of claims of the senior class at the time of a sale, it may not be possible to ascertain the IJC or the amount of ROV. These open items must, however, be resolved in order to distribute sale proceeds and to determine the IJC for purposes of the Deathtrap Provision.

The Commission acknowledges that there are numerous issues related to the ROV proposal that require "further development to determine whether and how it should be applied in more complex contexts," including:

- Whether a senior class should be required to pay ROV when it does not have a blanket lien and is entitled to less than all of the firm's enterprise value;
- Whether an IJC (or member of an IJC) can recover ROV if it is subject to contractual or structural subordination (rather than a lien subordination);
- Who pays ROV when there are multiple classes senior to the IJC and not all are receiving interests in the residual value of the firm;

- Whether ROV is payable when only part of the IJC class objects to a sale or challenges reorganization value under a plan; and
- Whether ROV is payable to the IJC if the IJC receives some distribution but is not paid in full.

Report, at 211.

There are at least three other issues left unresolved in the Report. First, the Report does not include a definitive methodology for calculating ROV. The Commission concludes that a market-based method such as the Black-Scholes model would "*likely* be the best way to consistently and accurately determine" ROV. Report, at 221 (emphasis added). The Report, however, also notes that other formulas, such as the Binomial Options Pricing Model and Monte Carlo options model, could be considered where "Black-Scholes is not effective to value an option on a particular enterprise." Report, at 221 n.795. The Report thus leaves open the question of what methodology, if any, courts should presumptively accept in determining ROV.[5]

In addition, the Report does not address whether the IJC will forfeit its right to ROV if it (or any member of such class) objects to the sale or plan on grounds other than those related to valuation (e.g., objections based on process, or whether the plan/sale was proposed in good faith, etc.). Further, the Report does not address the impact the ROV proposal may have on reorganized companies' balance sheets when they emerge from bankruptcy. Because, in the plan context, ROV would be payable only by the class(es) receiving residual interests in the company, senior lenders may be less willing to accept plan distributions in the form of equity interests and instead opt for debt instruments that effectively give them control of the reorganized company. This may, in some cases, cause debtors to emerge with an overleveraged balance sheet and make a second bankruptcy filing more likely in the near term.

Conclusion

The ROV proposal is controversial and represents a sharp departure from existing law. It would, if enacted as proposed, have material adverse impacts on the rights and recoveries of secured creditors.[6]

Authored by Michael L. Cook (+1 212.756.2150 | michael.cook@srz.com), Lawrence V. Gelber (+1 212.756.2460 | lawrence.gelber@srz.com), Adam C. Harris (+1 212.756.2253 | adam.harris@srz.com), David M. Hillman (+1 212.756.2174 | david.hillman@srz.com), Karen S. Park (+1 212.756.2036 | karen.park@srz.com) and Aaron B. Wernick (+1 212.756.2585 | aaron.wernick@srz.com).

---

[5] Regardless of which methodology courts apply to determine ROV, the ROV proposal may present new challenges for valuation experts. Under existing valuation practices, experts provide a range of values for a firm at a given point in time. This approach recognizes the inherent difficulty in assigning a precise value to a diverse set of assets. Despite these challenges, the ROV proposal would require experts to pinpoint the value of a firm at a future date. The proposal should thus clarify that, absent other factors, mere valuation errors cannot form the basis of a claim that reorganization value was proposed in bad faith.

[6] The ROV proposal would not apply to a small or medium-sized enterprise, which is defined in the Report to mean "a business debtor with (i) no publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's case, and (ii) less than $10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date." Report, at 279.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

Schulte Roth & Zabel
New York | Washington DC | London
www.srz.com

Bloomberg BNA

BNA's
Bankruptcy Law Reporter™

Asset Sales: ABI Commission's Recommendations Could Make Value Realization by Secured Creditors a Waiting Game of Diminishing Returns

By Lawrence V. Gelber and James T. Bentley

The American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the ''*Commission*'') recently issued a report (the ''*Report*'') containing numerous recommendations to reform Chapter 11 of the Bankruptcy Code (26 BBLR 1688, 12/11/14). Many of the recommendations appear innocuous, yet if they are adopted by Congress their effect could be far-reaching. Some of the most dramatic changes relate to the Commission's proposed changes regarding asset sales.[1] In this article, we focus on the effect these proposed changes would have on secured creditors and the distribution of sale proceeds.

Lawrence V. Gelber *is a partner in the Business Reorganization Group at Schulte Roth & Zabel LLP where his practice concentrates in the areas of distressed mergers & acquisitions, debtor-in-possession financing, corporate restructuring, creditors' rights and prime brokerage insolvency/counterparty risk. His extensive experience in Chapter 11 reorganization cases includes his representation of debtors, secured and unsecured creditors, lenders, investors and acquirers.*

James T. Bentley *is a special counsel in the Business Reorganization Group at Schulte Roth & Zabel LLP where he represents financial institutions, private equity firms, multi-employer benefit funds and others in reorganizations, complex litigation and out-of-court workouts.*

While many Chapter 11 debtors seek to reorganize pursuant to a plan of reorganization, a debtor also may seek to sell all or substantially all of its assets in what the Commission refers to as a section 363 sale, outside of a plan of reorganization.[2] On a macro level, the Commission found few differences between the net effect of a section 363x sale and confirmation of a plan of reorganization. Both result in the fixing of the ''maximum recovery any particular creditor will receive in [a debtor's] case.'' Report at 204. While the Commission found little difference between the *consequences* to creditors' rights and claims under a section 363x sale order or plan confirmation order, it observed significant differences in the creditor *protections* available in each of these processes. Report at 206. Thus, the Commission proposed several key revisions to section 363 of the Bankruptcy Code intended to more closely align the standards for approval of section 363x sales with the standards for plan confirmation.

[1] The Report differentiates between discrete sales of assets outside the ordinary course of business and sales of all or substantially all of a debtor's assets, which the Commission refers to as ''section 363x sales.'' The Commission recommended very few meaningful changes to the current manner in which the Bankruptcy Code addresses discrete asset sales, but it recommended a number of significant procedural and substantive changes to the provisions governing section 363x sales. Our focus in this article is on the latter, and thus our discussion of the Commission's proposed changes to provisions of the Bankruptcy Code affecting all asset sales is not intended to be exhaustive.

[2] Section 363 of the Bankruptcy Code addresses a debtor's use, sale or lease of its property. Generally, a debtor is permitted to use or sell its property in the ordinary course of its business without court approval. If a debtor wants to use or sell its property outside the ordinary course of its business, it must first obtain court approval on notice to parties in interest. Critically, the Bankruptcy Code permits a debtor to sell its property free and clear of interests in that property (such as liens) under certain conditions. 11 U.S.C. § 363(f). This ability to sell property free and clear of interests is intended to enhance the property's value, maximize creditor recoveries and provide comfort and certainty for buyers.

 ISSN 1044-7474

1. Adoption of the Commission's Recommendations Would Impose Additional Requirements for Approval of a Section 363x Sale

Under the current Bankruptcy Code, section 363x sales can be accomplished relatively quickly with few of the procedural or substantive requirements required for plan confirmation. For instance, to confirm a plan, all impaired creditors entitled to receive a distribution may vote on the plan. Further, the plan proponent must show, among other things, that: (a) all administrative claims and certain priority claims will be paid in full in cash on the effective date of the plan;[3] (b) creditors will receive at least as much under the plan as they would in a chapter 7 liquidation (the ''best interests test''); and (c) the plan is ''fair and equitable'' (*i.e.*, the plan does not provide: (i) a greater recovery to one class of claims or interests with equal priority to another; or (ii) any recovery to a junior class if all more senior classes are not paid in full).[4] 11 U.S.C. § 1129.

Conversely, under the current Bankruptcy Code, creditors are not entitled to vote on a section 363 sale; a debtor need not satisfy the best interests test in connection with the sale; nor must a debtor provide for the payment in full in cash of all administrative claims on the closing date.[5] Finally, the Bankruptcy Code does not require the debtor to disclose how the sale proceeds ultimately will be distributed.

To address the potential for inconsistent outcomes in the section 363x sale and plan processes, the Commission has recommended that approval of a section 363x sale should be based on many of the same factors that apply to confirmation of a so-called ''cram-down plan.''[6] The Commission thus suggests that for a court to approve a section 363x sale, among other things:

- All administrative expense claims incurred through the sale closing date must be paid in full in cash, or reserved for, unless the holder of an affected claim agrees to a different treatment for its claim;
- A debtor should not be permitted to conduct an auction of, or to receive final approval of a sale of, all or substantially all of its assets within the first 60 days after the petition date or the date an order for relief is entered;
- The sale should meet the ''best interests test'';
- Any ''redemption option value'' payable to unsecured creditors must be paid from sale proceeds (another recommendation of the Commission);[7]
- Payments made in connection with the sale (*e.g.*, purchaser's costs and expenses) must be approved by the bankruptcy court; and
- The section 363x sale should be followed by a plan or a conversion to chapter 7 — ''structured dismissals'' would no longer be permitted.[8]

2. What Do the Proposed Changes Mean for Secured Creditors?

The Commission's recommendations, if implemented, would provide debtors and statutory committees with additional leverage in negotiating carve-outs from secured creditors' cash collateral to fund administrative expenses.[9] Debtors and committees likely would demand larger carve-outs to, among other things, fund cases that will last longer (and cost more) and finance the wind-down of debtor's' estates post-sale.

Debtors and committees would have even greater leverage if the secured creditor intends to credit bid for its collateral.[10] The Commission's recommendations thus would have the practical effect of codifying a common, but undocumented, feature of many credit bid sales, *i.e.*, the ''tax and tip'' that secured creditors often

---

[3] The Bankruptcy Code defines administrative expenses as ''the actual, necessary costs and expenses of preserving the estate . . . .'' To qualify for priority treatment, the administrative expense must arise from a postpetition transaction with the debtor that was beneficial to the debtor's business operation in order to qualify for administrative status. 11 U.S.C. § 503.

[4] In the plan process, debtors must send to creditors a disclosure statement that includes ''adequate information'' about the case and the plan to allow creditors to make an informed decision on how to vote on the proposed plan. The Commission did not address whether to require similar disclosure in the section 363x sale process.

[5] Currently, bankruptcy courts often permit secured creditors to be paid from the sale proceeds at the closing of a section 363x sale with no assurance that the debtor's estate is administratively solvent (*i.e.*, that funds are available to satisfy all administrative claims).

[6] Section 1129(b)(2) of the Bankruptcy Code provides the standard by which a court evaluates whether a Chapter 11 plan is ''fair and equitable'' and can be confirmed over the objection of a class of claims — colloquially referred to as ''cramming down'' the objecting class.

[7] In addition to the recommended changes to the conduct and approval of asset sales, the Commission also recommended significant changes to how proceeds from asset sales would be distributed. The Commission's proposal would compel senior creditors to pay a mandatory ''tax'' — the so-called ''redemption option value'' — to junior stakeholders in certain circumstances. Simply put, this proposal, if enacted, would force senior creditors to give a portion of the value of their collateral to out-of-the-money stakeholders *even if the senior creditors are not being paid in full*. The proposal is a significant departure from fundamental bankruptcy principles, including the ''absolute priority rule,'' and would in many cases impair the expected recoveries of secured creditors.

[8] A so-called ''structured dismissal'' is a dismissal order that provides a mechanism for the bankruptcy court to retain jurisdiction over certain post-dismissal matters. Structured dismissal orders also often contain provisions typically found in a plan or sale order, such as releases and protocols for reconciling and paying claims.

[9] Current practice in many bankruptcy cases is for debtors, committees and secured creditors with liens in all or substantially all of a debtor's assets, including cash, to negotiate a carve-out from the secured creditor's cash collateral to fund administrative expenses, including professional fees, incurred during the bankruptcy case. This carve-out, which is documented in a cash collateral or financing order, permits a debtor to use the secured creditor's cash collateral pursuant to a budget agreed upon by the parties and subject to bankruptcy court approval. In exchange for the use of its collateral, the secured creditor typically receives ''adequate protection'' in the form of a replacement lien in cash the debtor receives after the petition date and a release of any potential claims against the secured creditor in its capacity as such.

[10] A ''credit bid'' allows a secured creditor to offset the purchase price by the amount of its secured claim, a right expressly provided for in section 363(k) of the Bankruptcy Code.

   ISSN 1044-7474

pay to ensure a consensual sale order.[11] When a secured creditor credit bids for its collateral, it may also agree to fund post-sale wind-down expenses with cash pursuant to a budget, provided that the creditor wins the auction. In exchange for funding these wind-down expenses, the secured creditor typically receives an additional release in the sale order of any potential claims against the secured creditor in its capacity as credit bid purchaser.

In many cases, the bulk of these wind-down expenses are not technically the responsibility of the secured creditor. In fact, section 506(c) of the Bankruptcy Code only permits a debtor to surcharge a secured creditor's prepetition collateral for ''the reasonable, necessary costs and expenses of preserving, or disposing of, such property'' to the extent those costs provide a benefit to the secured creditor.[12] Many line items contained in a wind-down budget, however, are for payments that do not directly benefit the secured creditor (hence, the term ''tax and tip''). Yet secured creditors often agree to pay these additional expenses in exchange for the additional release in the sale order and to avoid the risk and expense of litigating with a creditors' committee or other out-of-the-money constituency. Further, many bankruptcy courts are disinclined to approve sales when all known administrative expenses incurred through the closing date are not paid, or otherwise provided for, in connection with the sale closing. This arrangement benefits the estate in at least two ways: first, it provides for the payment of costs that otherwise might not be paid in a Chapter 7 liquidation; and second, it enhances the potential for some distribution to unsecured creditors. If the estate's administrative expenses ultimately exceed the agreed-upon wind-down budget, however, the creditor has no responsibility to finance the excess expenses because of the release it receives under the sale order. As noted, while paying some ''tax and tip'' is common practice, there is no requirement that a secured creditor fund the payment of administrative expenses unrelated to its collateral in order for a court to approve a sale. Thus, under the current Bankruptcy Code, it is possible that some administrative expenses incurred through the sale closing date will go unpaid.

If the Commission's recommendations are enacted though, *all* administrative expenses incurred through the sale closing date *must* be paid in full or reserved for as a prerequisite to sale approval. This requirement would be *in addition to* section 506(c) of the Bankruptcy Code, which, as discussed, provides that a debtor may surcharge a secured creditor's prepetition collateral for costs associated with preserving or disposing of its collateral. In other words, requiring that all administrative expense claims be paid at the closing of a section 363x sale effectively expands the scope of section 506(c) to permit a debtor to surcharge *both*: (a) a creditor's prepetition collateral for the costs associated with preserving and selling that collateral; and (b) the proceeds of the sale of the creditor's collateral (including any postpetition collateral the creditor obtains during the case) to fund *any* administrative expense — even expenses unrelated to preserving and selling its collateral.[13] If there is no unencumbered cash in the estate, a creditor would be required to fund all administrative expenses incurred through the sale date in order to obtain bankruptcy court approval for the sale.

To put a finer point on this, the requirement that all administrative expenses be paid negates the utility of a budget in a cash collateral order. For example, if professionals for a statutory committee exceed the amount budgeted for their fees, but their fees are allowed by the bankruptcy court, the entirety of those fees would constitute administrative expenses required to be paid (or reserved) before the bankruptcy court could approve the sale. This single change alone thus could create significant moral hazard as committees will be incentivized to pursue long-shot litigation against secured creditors knowing that the expense for the litigation must be paid (if allowed), and ultimately may be borne by the secured creditor itself.

3. Additional Concerns for Secured Creditors Regarding the Payment of Administrative Expenses

The requirement that all administrative expense claims incurred through the sale closing date be reserved for or paid in full raises two additional concerns for secured creditors. First, how is the debtor or the court to determine the amount of administrative expenses that have been ''incurred'' by the estate through the closing date that must be paid or reserved from the sale proceeds? Indeed, it is doubtful that all administrative expense claims will be known — or even calculable — by a debtor or its creditors on the section 363x sale closing date. Examples of ''hidden'' administrative expenses that may not be ascertainable until long after closing include:

- Any payment obligation that is only paid periodically (such as annually or quarterly) and that might not be reflected on a 13-week cash flow statement (but that are effectively accruing daily);

[11] Even if a secured creditor has filed a UCC-1 asserting an ''all asset'' lien in the debtor's property, bankruptcy may expose deficiencies in its collateral package. For example, to perfect a lien in motor vehicles that do not constitute inventory, a secured creditor is required in many states to note its lien on the vehicle's certificate of title. Many secured lenders do not bother to do so. Thus, if its borrower becomes a debtor, the lender's liens on the motor vehicles are not perfected vis-à-vis the debtor's other creditors. Further, as a general rule, section 552(a) of the Bankruptcy Code invalidates after-acquired property clauses in prepetition security agreements, cutting off a secured creditor's lien in after-acquired property on and after the petition date. Thus, debtors often have some assets that are unencumbered. The secured creditor cannot use credit bid currency to purchase these assets and, typically, must instead pay cash.

[12] 11 U.S.C. § 506(c). While debtors sometimes agree to waive their rights under section 506(c) in cash collateral or DIP financing orders, the Report recommends that debtors no longer be permitted to do so.

[13] This result is in direct contrast to the Commission's stated intention in the Report to *not* expand the scope of Section 506(c). Report at 229 (''The Commission determined that the current scope of section 506(c) was appropriate, and that the required nexus between the estate's expenditures and the secured creditor's collateral was an appropriate gating feature of this provision.'').

- Payments that become due postpetition for a period that straddles the petition date;[14]
- Taxes (*e.g.*, those resulting from a gain on the sale of assets);
- Claims for pre-closing breaches of assumed contracts;
- Insurance (particularly retroactive premium adjustments payable for prior periods under insurance programs that have been ''assumed'' in the bankruptcy case);
- Liability arising from failure to comply with the Worker Adjustment and Retraining Notification Act; and
- Any other claim resulting from the postpetition/pre-sale closing conduct of the debtor.

Second, the Report does not address how to allocate payment of these administrative expenses when there are unencumbered assets in the bankruptcy estate. Will secured and unsecured creditors be required to fund administrative expense claims incurred through the sale closing date *pro rata*, on a 50/50 basis, or will they be forced to litigate to determine which constituency is responsible for payment of which administrative expense claims? The Report is silent on this issue.

The potential for a court to require debtors to reserve sale proceeds pending the calculation of pre-closing administrative expenses and the attendant litigation risk that secured creditors would face regarding the allocation of the obligation to satisfy those expenses are troubling. In some instances, this requirement may even doom a sale at the outset or result in a case converting to a liquidation under Chapter 7.

4. The 60-Day Auction Moratorium Likely Will Increase the Cost of Cases — Perhaps Needlessly

The Report recommends that a debtor should not be permitted to conduct an auction of, or to receive final approval of a sale of, all or substantially all of its assets within the first 60 days after commencing its Chapter 11 case.[15] The Report provides that a court may shorten the time for an auction or sale to less than 60 days, but only if a party in interest demonstrates by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during such 60-day period *and* the court finds that the proposed sale satisfies the standards (as proposed) for a section 363x sale.

As justification for the 60-day moratorium, the Commission cites research showing that bankruptcy sale processes have become more abbreviated since the early 2000s. Report at 84-86.[16] While the Commission noted that there were several benefits to quick sales (*e.g.*, shorter cases are cheaper and typically preferred by creditors and stalking horse bidders), it ultimately ''found that in many cases the *potential* harm to the estate from a sale that is pushed through more quickly than necessary under the circumstances significantly outweighs any potential benefits of such sale.'' Report at 87 (emphasis added). The Commission, however, provided no evidence that expedited sales *actually* harm the estate, noting that there is little empirical data on section 363x sales. Report at 203. Further, the Commission appears to have ignored the reality that many debtors market themselves for weeks, if not months, before seeking bankruptcy relief. Thus, even abbreviated sales in bankruptcy may be the result of a comprehensive sale process.

There is no guarantee that imposing a mandatory 60-day moratorium will result in increased sale proceeds. In fact, when a prepetition sale process has already occurred, running that process a second time likely would only increase the administrative burden — and expenses — to the estate, with no discernable benefit. Further, administrative expense claims may also increase if the recommended moratorium is implemented because the sale process will take longer and debtors will incur more professional fees. This problem would be compounded by the additional professional fees of other parties in interest payable by the estate (*e.g.*, committees, indenture trustees, DIP lenders, etc.). Thus, the financial burden that may ultimately be borne by creditors in connection with these new sale requirements could become significant.

The 60-day moratorium may provide some benefit to debtors who ''free fall'' into bankruptcy, but for those debtors whose property already was adequately marketed pre-bankruptcy, it may be a needless and costly additional hurdle.

5. Clarifying the Scope of ''Free and Clear'' in Section 363x Sales is a Mixed Bag for Secured Creditors.

Under Section 363(f) of the Bankruptcy Code, a debtor may sell its property free and clear of any ''interest'' in the debtor's property if the sale meets certain requirements.[17] The Bankruptcy Code, however, does not

[14] For example, the Third Circuit has held that the postpetition portion of the liability incurred by a debtor for withdrawing from a multi-employer benefit plan (*i.e.*, withdrawal liability) is entitled to payment as an administrative expense claim. *In re Marcal Paper Mills, Inc.*, 650 F.3d 311 (3d Cir. 2011).

[15] The Commission recommends that a court may shorten the 60-day moratorium on a section 363x sale — whether or not the secured creditor has requested or received adequate protection of its interest — if the risk of decline in value of the debtor's assets is sufficient to warrant a sale before the expiration of the 60-day period. This would be a dramatic departure from the current statute, which *requires* a court to prohibit or condition sales under Section 363 as is necessary to provide adequate protection on request of an entity that has an interest in the property being sold. *See* 11 U.S.C. § 363(e).

[16] According to the research contained in the Report, which is based only on large public company filings, the average number of days between the petition date and the sale date declined from approximately 352 days (from 1990 through 2006) to approximately 100 days (from 2007 through 2013).

[17] A court may approve a sale of a debtor's assets free and clear of interests in those assets if:

(1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f).

   ISSN 1044-7474

define the word ''interest.'' Further complicating matters, the Bankruptcy Code describes a different treatment for assets sold under a plan. Specifically, ''property dealt with'' (*e.g.*, sold) under a plan of reorganization is transferred free and clear of ''*claims and* interests.'' 11 U.S.C. § 1141(c) (emphasis added). Thus, some courts have questioned whether assets sold under a plan of reorganization actually are entitled to a broader release than assets sold in a section 363 sale. Report at 143. Courts also have differed on, among other things, whether the proceeds from the sale of the debtor's property must exceed the face value of the secured claims asserted against the property in order to sell the property free and clear of all liens, claims and encumbrances. Report at 143-44.

In an effort to provide clarity on these points, the Commission has recommended that a debtor's assets receive the same type of release regardless of whether they are sold under a plan or in a section 363x sale. According to the Commission, permitting a debtor to transfer clear title to a purchaser is value-enhancing and will permit debtors to achieve higher sale prices, thus benefiting the estate. Specifically, the Commission has recommended the following:

- A debtor should be able to transfer property free and clear of ''all liens, interests, and claims, including, without limitation, civil rights liabilities, and any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales'';

- Interests expressly *excluded* from free and clear sales include: (i) successorship liability for purposes of federal labor law,[18] and (ii) certain obligations that are deemed to ''run with the land'' under applicable nonbankruptcy law;[19]

- A debtor should not be permitted to sell or transfer assets under section 363(f) in a manner that violates or impedes ''the police or regulatory power of the federal or a state government to the extent that such government could enforce those rights against the debtor or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code''; and

- A debtor should be able to sell its assets free and clear of interests, without the consent of any lienholder, regardless of whether the sale proceeds exceed the aggregate value of the liens in the assets, provided that the liens attach to such sale proceeds or the lienholder receives adequate protection of the lien. This requirement appears to be applicable whether or not the secured creditor will (or will not) credit bid for its collateral.

Acquirers of assets in section 363x sales will probably welcome these changes because they provide clarity on the types of liabilities that remain with the estate and the likelihood of closing. Debtors and unsecured creditors also would benefit from these changes, for they may result in higher bids and additional sale proceeds. Secured creditors, on the other hand, should be concerned. In particular, creditors today typically oppose efforts to sell their collateral for less than the face amount of their claims, and the Commission's recommendation would eliminate this protection. This may be less of a concern, however, for creditors willing to credit bid for their assets.

6. The Chilling Effect of Credit Bidding Would Be Eliminated as ''Cause'' to Limit a Creditor's Credit Bid Right

Section 363(k) of the Bankruptcy Code permits a secured creditor to credit bid the allowed amount of its claim in any sale of its collateral, unless the bankruptcy court ''for cause'' orders otherwise. ''Cause'' is not defined in the Bankruptcy Code and is left to the discretion of the court. Recent court decisions have limited a secured creditor's right to credit bid ''for cause'' when the court found that permitting credit bidding (in whole or in part) might ''chill'' a competitive auction process.[20] The Commission's recommendations appear to be aimed at curbing the effect of these cases. The Report notes that *all* credit bidding chills an auction process to some extent. However, the Commission concluded that the mere existence of a chilling effect should not preclude a creditor from exercising its statutory right to credit bid. Report at 147. The Commission thus recommends that courts should attempt to mitigate any chilling effect by managing the entirety of the auction process (*e.g.*, restricting efforts by secured creditors to discourage a competitive bidding process). If enacted, this would be a victory for secured creditors because it should end the recent attempts to limit credit bid rights ''for cause'' on the ground that a creditor's credit bid might chill bidding.[21]

Conclusion

The Commission's proposals regarding section 363x sales will result in the sale process — and perhaps cases themselves — taking longer and costing more, without

[18] The Report does not specify the meaning of successor liability under federal labor law, but this term would seem to include, for example, claims for wage and hour violations under the Fair Labor Standards Act.

[19] The complete list of interests listed in the Report that a debtor cannot sell free and clear in a section 363x sale are: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to ''run with the land'' under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to ''run with the land'' under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing or disputed ownership interests, except to the extent specified in Section 363(h) or (i). (Section 363(h) provides that a debtor may sell both the estate's interest and the interest of any co-owner in property in which the debtor had, at the time of the commencement of the case, an undivided interest (*e.g.*, marital property) under certain circumstances. Section 363(i) provides that such co-owner has a right of first refusal at any asset sale.)

[20] *E.g.*, *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 BL 37766 (D. Del. Feb. 12, 2014); *In re Free Lance Star Publ'g Co. of Fredericksburg, Va.*, 512 B.R. 798 (Bankr. E.D. Va. 2014), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

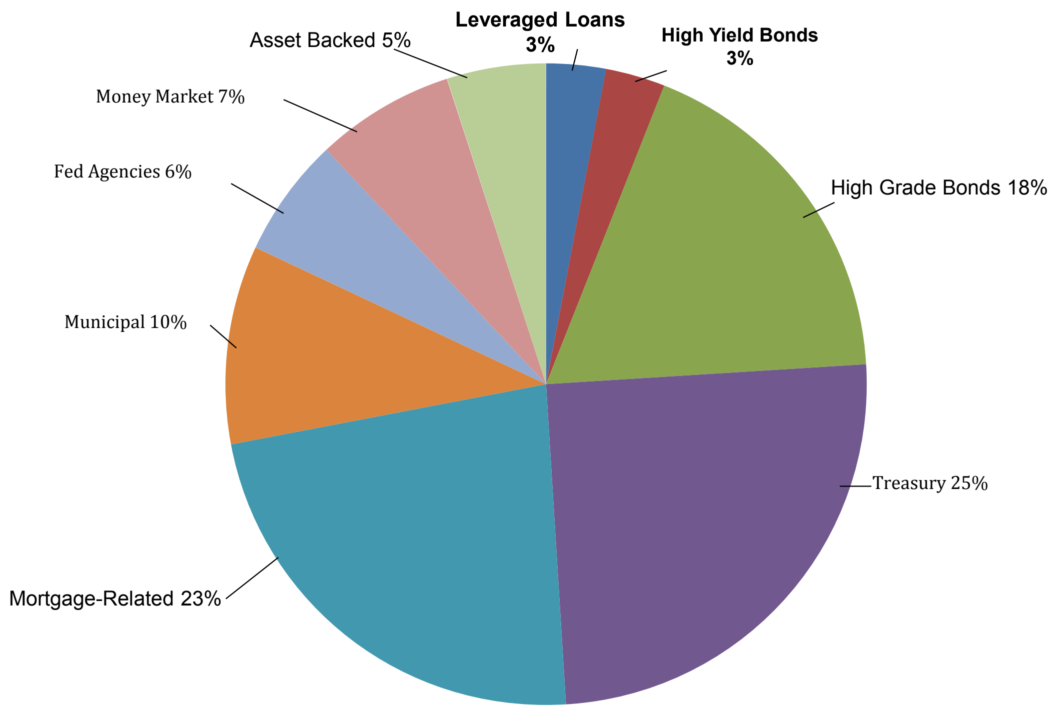
[21] The Commission's recommendation, if approved, would bring section 363x sales in line with plan sales, which have most recently been addressed in the U.S. Supreme Court's decision *RadLAX Gateway Hotels, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*, 132 S. Ct. 2065 (U.S. 2012) (plan providing for the sale of collateral free and clear of a secured creditor's lien must permit the creditor to credit bid at the sale).

any certainty that the additional time or expense will result in greater recoveries for creditors. More troubling, the Commission's recommendations may mean significantly lower recoveries for secured creditors, and higher borrowing costs for debtors as a result.

That said, acquirers should welcome the Commission's recommendations, which would expand the scope of free and clear sales. Secured creditors should also be pleased with the clarification that the potential ''chilling effect'' of credit bidding at an auction does not constitute ''cause'' to deny a secured creditor a right to credit bid the allowed amount of its claim.

   ISSN 1044-7474

Leverage Loans and High Yield Bonds Represent More than 6% of U.S. Fixed Income Asset Classes



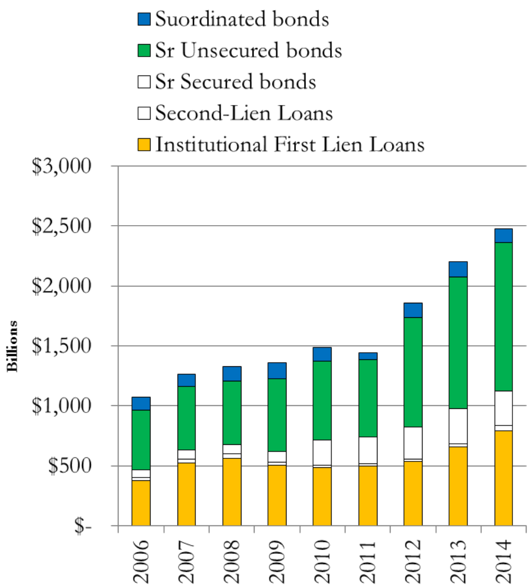
Total Size of Fixed Income Market $38 Trillion

1

There is Almost $2.5 Trillion in Total Leveraged Debt Outstanding

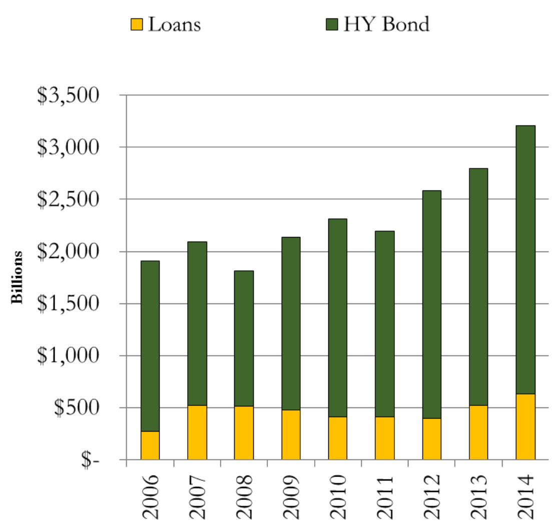
With $3.2 Trillion Traded Annually by Year-End 2014

Leveraged Debt Outstanding



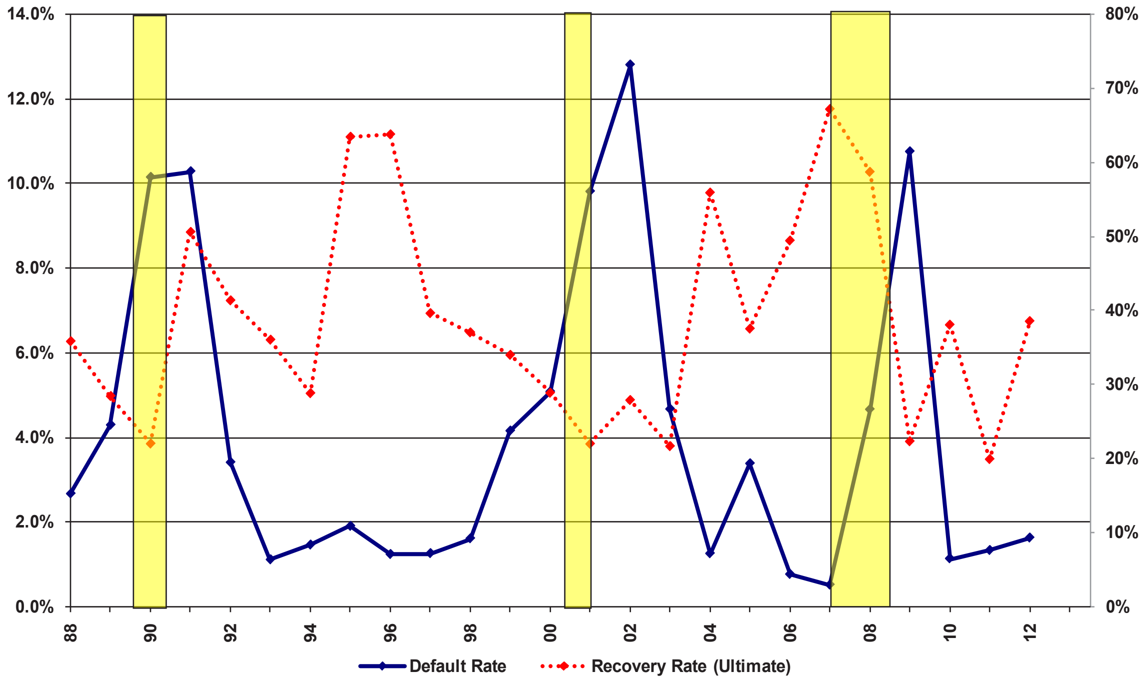
Source: S&P Capital IQ LCD

Leveraged Debt Secondary Trading Volume



Source: Thomson Reuters & LSTA Trade Data Study

Historical Default and Recovery Rates (Ultimate) vs Recession Periods in the U.S.: High-Yield Bond Market, 1988-2012



Periods of Recession: 7/90-3/91, 4/01-12/01, 12/07-6/09.

Source: Moody's Ultimate Recovery Database and National Bureau of Economic Research.

3

Chapter 11 Process

Illustrative traditional Chapter 11 timeline