AMERICAN BANKRUPTCY INSTITUTE

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Secured Creditor Issues

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Secured Creditor Issues in Chapter 11 Bankruptcies: *Basics and Overview of Recent Developments*

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Outline of Presentation

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DIP Financing Basics

DIP Financing Basics

Policy Objectives

- Congress understood that lenders might be reluctant to extend credit to companies filing for bankruptcy**.**
  - In order to incentivize lenders to extend credit to debtors, Congress granted bankruptcy courts broad discretion to provide extraordinarily strong protections to DIP lenders.
- The overarching goal is to ensure that debtors are able to access credit markets to fund ongoing operations, bankruptcy-related expenses, and, if possible, reorganize as a going concern.

Statutory Framework

- Section 364 of the Bankruptcy Code is the provision governing DIP financing and permits debtors to obtain credit in and out of the ordinary course of business and with a variety of priorities.
  - A debtor is always required to demonstrate to the court that postpetition credit is not available on more favorable terms.
  - The DIP financing framework is extremely comprehensive, and was crafted to work alongside the protections afforded by the U.S. Constitution to prepetition secured creditors.

DIP Financing Basics (cont'd)

DIP Financing Options

Section 364 sets forth a menu of DIP financing options, each with escalating levels of protection for the lender and requirements for obtaining such protection.

1. ***Unsecured DIPs***. Although relatively rare in recent practice, debtors are permitted to obtain financing on an unsecured basis.
   - As a means of basic protection, the DIP lender's claim will be accorded administrative expense priority status (*i.e.*, such claim will be paid before general unsecured claims and unsecured priority claims, but after secured claims and certain limited categories of administrative expense claims)
   - Courts may also grant DIP lenders a "super-priority" administrative expense claim that is senior to all other administrative expense claims.
2. ***Secured DIPs***. In the more common scenario, where unsecured DIP financing is not available (*e.g.*, because of prevailing market conditions or a debtor's poor financial prospects), debtors will seek to obtain DIP financing on a secured basis.
   - Where a debtor has assets available that are not encumbered by existing liens, DIP lenders are typically granted first-priority liens on any unencumbered property.
   - Where a debtor does not have any unencumbered assets available (*e.g.*, due to existing secured debt or other limitations on the ability to collateralize a debtor's assets), DIP lenders are typically granted a junior lien on such property.

DIP Financing Basics (cont'd)

DIP Financing Options (cont'd)

3. ***Priming DIPs***. If credit remains unavailable under options (1) or (2), the court authorizes DIP financing secured by liens that rank *pari passu* to or senior to (*i.e.*, prime) existing security interests.
   - In some cases, prepetition secured lenders consent to being primed in exchange for a package of protections (*e.g.*, current pay interest and payment of legal fees).
   - Absent such consent, however, the court will only authorize the granting of priming liens if it finds that the existing security interests will be "adequately protected," notwithstanding the imposition of such liens.
   - Adequate protection typically takes the form of some combination of the following:
     - Cash pay interest or other cash payments (*e.g.*, payment of legal fees).
     - Supplemental liens on new collateral and/or replacement liens on existing collateral.
     - Establishing the existence of an "equity cushion" in the collateral (*i.e.*, that the value of the collateral exceeds the combined value of the existing security interest and the proposed DIP lien).
       - This often requires the submission of significant valuation evidence at the very early stages of the debtor's bankruptcy case, which may limit strategic options down the road (*e.g.*, a different plan valuation).

DIP Financing Basics (cont'd)

Adequate Protection Fights

- As noted, the establishment of an equity cushion often requires extensive valuation evidence–which often leads to expensive and generally unpleasant litigation.
  - An equity cushion in the range of 15-20% will generally constitute adequate protection.
  - Equity cushions have become increasingly difficult to prove in recent years, due, in part, to the replacement of unsecured mezzanine and high-yield financings with secured second lien financings.
- To avoid adequate protection disputes (often referred to as "priming fights"), many debtors seek to obtain the consent of their prepetition secured lenders, with some debtors even seeking such consent prior to the commencement of the bankruptcy case.
  - Any consent to priming is often only obtained at a cost.

DIP Financing Basics (cont'd)

Roll-Up DIP Facilities

- Where the prepetition secured lenders become a source of DIP financing, such lenders may seek to "roll-up" their prepetition loans into DIP financing loans.
  - If a court authorizes a roll-up, all or part of prepetition indebtedness is "rolled" into and repaid by (or deemed to be repaid by) an equivalent participation in the DIP facility.
  - As DIP facility claims, such rolled-up claims must be paid in full in cash if a reorganization plan is to be confirmed, thereby eliminating any cramdown risk.
- Roll-ups typically take one of two forms:
  - A *pro rata* roll-up allows each lender to roll up an amount proportionate to its share of the prepetition loan, regardless of whether such lender provides any new money as part of the DIP financing.
  - A "dollar-for-dollar" roll-up only applies to those prepetition lenders that extend new money; those lenders that do not provide new capital do not receive the benefits of the roll-up.
- In certain circumstances, prepetition secured lenders may be able to negotiate a roll-up as a form of adequate protection without providing any new money.
  - This can occur where the DIP lender and the debtor want to avoid a complex and protracted valuation fight.

Customary Features of DIP Financing Loans

Customary Features of DIP Financing Loans

Negotiation of DIP Loans

- In larger cases, DIP loans typically are negotiated over a several-week period just prior to the commencement of the debtor's chapter 11 case.
  - DIP lenders typically will insist on a first-priority priming lien on the debtor's inventory, receivables, and cash (whether or not previously encumbered), a second lien on any other encumbered property, and a first-priority lien on all of the debtor's unencumbered property.
- Strategic DIP lenders (often from within the existing capital structure) frequently insist that milestones and other case controls be included in the DIP order.
  - These are commonly referred to as "defensive DIPs."
- The DIP order will also include bankruptcy-specific protections that make it much easier for the DIP lender to exercise remedies in a default scenario.

Customary Features of DIP Financing Loans (cont'd)

Pricing and Economics Terms

- Pricing will often include a fee paid at the time of the initial commitment letter, further fees paid at the time the loan is closed, and ongoing commitment fees.
  - During periods of credit market stability, DIP financing facilities have earned interest in the area of L+ 4-6%

Syndication and Maturity

- Syndication of larger DIP facilities often waits until after the commencement of the chapter 11 case.
  - Sometimes the lead arranger underwrites the entire facility; other times a small group of initial participants is included.
- Maturity dates are typically 1-3 years, but were much shorter during the 2008/2009 credit crisis.

Carve-Out

- Very limited carve-outs for professional and statutorily imposed fees.

Customary Features of DIP Financing Loans (cont'd)

Roll of Committee

- On occasion, as discussed in greater detail below, the Creditors' Committee will object to some terms of the DIP facility or the adequate protection package.
  - In most cases, the Creditors' Committee recognizes the need for the DIP facility, and any objections it has are resolved before the final DIP hearing; sometimes this is not the case and significant litigation ensues

Customary Sources of DIP Financing

- Although dynamics have changed somewhat in recent years, DIP lenders have typically included private equity firms, hedge funds, and commercial banks.
  - DIP loans have been attractive to traditional investors because of their steady returns and low-risk profile. A Moody's study shows that, of 297 cases of DIP facilities extended to large public companies from 1998 through 2008, there were only 2 defaults, and lenders were not repaid in only one case, *Winstar Communications*.
  - Strategic investors (often from within the existing capital structure) have been attracted to DIP loans because of the "loan-to-own" potential – *i.e.*, the ability to convert DIP loans into a majority of the equity in the reorganized company upon its emergence from chapter 11.

DIP Strategies

DIP Strategies

DIP To Defensive Sale

- Faced with a debtor unable to reorganize with its own resources, prepetition lenders, seeking to preserve or realize upon the value of their collateral, will often provide DIP financing to facilitate an asset sale.
  - **Limited Funding**
    - Lenders will typically limit the funding to an amount sufficient to provide the Debtors with sufficient "runway" to consummate a sale.
  - **Sale Milestones**
    - The DIP Credit Agreement will typically contain "milestones" with respect to implementation of a sale process. Often, lenders seek to expedite this process, sometimes seeking approval of consummated sales in as little as 45 to 60 days.
  - **Credit Bidding Protections**
    - The lenders will hope for a third-party sale at a price that clears their debt, but to ensure that value is protected if no acceptable bids are received, the DIP Order will contain provisions that reaffirm the lenders right to "credit bid" their debt and take the assets.
  - **"Funeral" or Wind-Down Expense**
    - In order to successfully consummate a credit bid sale, lenders will often be compelled to fund "funeral" or wind-down expenses for the debtor and its creditors. Courts maintain that chapter 11 cases are not for the sole benefit of secured lenders, so, under these circumstances, secured lenders are required to leave behind a pot of cash to "tip" the unsecured creditors and fund a liquidation plan process.

DIP Strategies (cont'd)

DIP To Confirmed Plan

- Faced with a debtor with brighter prospects and the apparent ability to reorganize successfully, lenders will frequently provide DIP financing to fund a reorganization process.
  - **Long-Term Funding**
    - In these circumstances, the funding provided will be more substantial and intended to serve the debtor's needs over a number of 13-week budget periods, often for up to two years.
  - **Roll-Up and Take-Out Financing**
    - In these circumstances, it is not uncommon for the lenders to demand and receive "roll-up" or "take-out" of all or some part of their prepetition debt. As discussed above, an administrative expense claim granted pursuant to section to 364 of the Bankruptcy Code is preferable to a secured prepetition claim.
  - **Adequate Protection**
    - Under such circumstances, lenders will also seek and generally obtain a full package of available adequate protection benefits, including replacement liens, current pay interest and payment of legal fees.
  - **Releases and Exculpation**
    - Finally, the lenders will seek and generally obtain all of the releases (for prepetition conduct) and exculpation (for plan-related conduct) provided to other plan proponents.

DIP Strategies (cont'd)

DIP To Exit Financing

- Other DIP financings have included the option to convert outstanding amounts on the DIP loan to exit financing.
  - **Enhanced Ability to Reorganize**
    - Like equity conversions, these financings enhance the debtor's ability to reorganize by reducing amount that must be raised at emergence.
  - **New Lenders**
    - Unlike most defensive DIP financings, DIP financings with DIP-to-Exit feature often attract non-incumbent lenders eager to build a new banking relationship with a borrower it views as likely able to successfully reorganize.
  - **Representative Cases**
    - DIP to Exit Financing features were approved in the chapter 11 cases of *Houghton Mifflin Harcourt* and the *American Airlines*.

DIP Strategies

DIP To Equity Conversion

- **Some DIP financings include option to convert outstanding DIP loan amounts to equity in reorganized debtor**
  - **Equity Upside**
    - Such conversions grant lenders a potential equity upside.
    - Also reduce amount of cash lenders must raise in unfavorable markets to repay the DIP loan on emergence. This is desirable for lenders wishing to execute a loan-to-own strategy.
    - Equity conversion features were included in the *General Growth Proper*ties and *ION Media Networks* DIP loans
  - **Disfavored by Courts**
    - However, these arrangements are not favored by courts because they are at the expense of unsecured creditors, who may have otherwise received this value.
    - As the credit markets have improved, the number of equity conversions have declined

First Day Menu: Do's and Don'ts on Day One

Overview

- Due to pressing cash needs, a debtor will generally seek approval of any DIP facility it proposes, as well as its ability to use "cash collateral," at a hearing (the "First Day Hearing") held the same day—or, more likely, the day after—it files its chapter 11 petition.
- The debtor will seek all the relief it needs, or believes it can obtain, at the First Day Hearing. However, due to the mandate imposed by Bankruptcy Rule 4001(c)(2) that the court "authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing," bankruptcy courts generally limit, by local rule or practice, the scope of what can be requested or obtained at a First Day Hearing. Fed. R. Bankr. P. 4001(c)(2).
- Thus, there are do's and don'ts as to a debtor's agenda for—and expectations coming out of—any First Day Hearing that are set forth, at a high level, on the following pages.
- There have been, and always will be, exceptions to the general rules and observations summarized below. However, as set forth herein, all the regular attendees at First Day Hearings, including the court, the debtor, the U.S. trustee, and any *ad hoc* committees already in place, generally follow the same script, so the scenarios that follow will generally play out as summarized.

Financial Terms and Structure

Interest Rates

- Interest rates on DIP loans historically were about 200 to 400 basis points above LIBOR.
  - However, in 2008 and 2009, pricing increased to the range of 600 to 1000 basis points or more above LIBOR. At the peak of the credit crunch, some DIP loans were priced at 1200 basis points above LIBOR.
  - Together with increasing fees (see below), DIP lenders received percentage point returns in the mid-to-upper teens (or higher) in 2008 and 2009.
  - Rates are now well off their 2009 peak, averaging LIBOR plus 675 basis points for term facilities, with revolving credit facilities (which are often asset-based facilities) generally averaging LIBOR plus 350 basis points. Experts predict that interest rates should continue to stabilize.
    - The debtor's financial advisor, as well as that of any objector, will be critical in demonstrating the "market" or "non-market" level of the proposed rates.

Fees

- DIP fees have included significant upfront and, less frequently, exit fees, each often in the range of 2% to 4% of the loan amount.
  - Upfront fees more recently have generally been closer to 2%. Initial arrangers have also demanded fees for arranging, underwriting and syndicating the loan.
  - However, increasing competition from DIP lenders, coupled with a relative scarcity of new DIP financings, resulted in a drop in these fees.
    - The debtor's financial advisor, as well as that of any objector, will be key voices as to the "market" or "non-market" nature and amount of the proposed fees.

Financial Terms and Structure (cont'd)

Attorney/Advisor Fees

- The debtor is generally obligated to reimburse the DIP lender for all of its attorney and advisor fees, regardless of whether incurred prepetition or postpetition, accrued in connection with the negotiation, documentation of the DIP facility and the conduct of the chapter 11 case.
  - **Any outstanding fees are generally recouped out of the first disbursement under the DIP loan.**
- The DIP lender is not a retained professional under section 327, but, by reluctant consensus, its fees and expenses have generally been subject to review by the U.S. Trustee and the creditors' committee in Delaware, New York and elsewhere.

DIP Break-Up Fees

- Under certain circumstances, a potential debtor may agree to pay a break-up fee to a prospective lender to entice the lender to provide the debtor with financing during its bankruptcy case.
  - Courts have sometimes approved and granted administrative claim status to such fees. *See, e.g.*, *In re The Original Soupman, Inc.*, Case No. 17-11313 (LSS) [Docket No. 136] (Bankr. D. Del. July 18, 2017) (approving 2.5% exit premium); *In re Suniva, Inc.*, Case No. 17-10873 (KG) [Docket No. 171] (Bankr. D. Del. May 19, 2017) (approving 2% exit premium); *In re Patriot Coal Corp.*, Case No. 15-32450 (KLP) [Docket No. 230] Bankr. E.D. Va. June 4, 2015) (approving 3% repayment or termination fee); *In re Hayes Lemmerz Int'l, Inc.*, Case No. 09-11655 (MFW) [Docket No. 237] (Bankr. D. Del. June 15, 2009) (approving 3% exit fee).
  - Other courts have concluded otherwise. *See In re C & K Market, Inc.,* No. 13-64561-fra11 (Bankr. D. Ore. April 8, 2014) (holding that break-up fee for prospective DIP lender was prepetition claim not entitled to administrative expense priority because any benefit attributed to the arrangement– including providing debtor with leverage in the negotiations with other DIP lenders – occurred prepetition, and not post-petition, a prerequisite to allowance as an administrative expense claim).

Financial Terms and Structure (cont'd)

Wildcard—Make-Whole Premium

- In connection with the recent chapter 11 filing (for the second time) of Gymboree Group, Inc. ("Gymboree"), the DIP lenders were granted a make-whole premium for a $10 million tranche of the overall $30 million DIP loan advanced to Gymboree.
  - More specifically, the premium was described as follows:

    A Make-Whole Amount, payable in the event the Class A DIP Loans are voluntarily prepaid or mandatorily prepaid upon consummation of an asset sale or receipt of casualty proceeds, letter of credit proceeds, or other extraordinary receipts, a Make-Whole Amount equal to 4.25% of the principal of such prepaid Class A DIP Loans plus all interest that would have been payable on such loans through the Stated Maturity Date.

  In re Gymboree Group, Inc., Case No. 19-30258 (KLP) [ECF No. 15] (Bankr. E.D. Va. Mar. 26, 2019).
- The Gymboree Make-Whole Amount was approved without objection by the U.S. Trustee or the Gymboree official committee.

Financial Terms and Structure (cont'd)

Structure

- While DIP loans were historically structured as unfunded revolvers, structures are increasingly including a funded term loan piece alongside a revolver.
  - This has been done to take advantage of strength in the institutional term loan market; and accommodate institutional investors that cannot hold unfunded commitments.
  - Such structures have increased the cost of the DIP loan because the debtor must pay interest on the entire amount of the funded loan rather than just a lower commitment fee on committed capital under the revolver.
  - In addition to traditional ABL/term "crossing lien" structures, some recent DIP facilities have used a "first-out, second-out" structure, with the ABL revolver having the first-out position on all collateral.

Underwriting and Syndication

- DIP loan arrangers almost always provide fully underwritten commitments, as potential debtors are reluctant to risk a bankruptcy filing without having committed bankruptcy financing.
  - Arrangers typically reserve the right to syndicate their commitments, but out of concern for confidentiality often agree not to do so before the bankruptcy filing has been made.
  - To reduce underwriting risk, deals are sometimes committed to by multiple arrangers, as in the leveraged loan market generally.
  - Market flex provisions serve to additionally reduce risk.

Financial Terms and Structure (cont'd)

Maturities

- Loan maturities, traditionally as long as two years, have been in decline.
  - However, they have been slightly increasing from 2009 lows of about nine months, to a current average of about 14 months.
  - In some cases they have been as short as three to six months, particularly in those cases that contemplate a quick section 363 sale of assets.
- These short loan durations have not provided debtors with enough time to reorganize, causing some debtors to liquidate rather than to successfully emerge from bankruptcy.
  - Such short maturities are generally paired with "rocket docket" milestones, and, as such and as discussed at greater length below, have often been challenged by U.S. trustees and official committees.

Collateral and Carve-Out

Scope of DIP Liens

- If the debtor can demonstrate that financing could not be procured on any other basis, the court can, subject to certain limitations, authorize the debtor to grant the DIP lender
  - Lien that has priority over pre-bankruptcy secured creditors (*priming lien*); and
  - Claim with super-priority over administrative expenses (including vendor and employee claims) incurred during Chapter 11 and over all other claims.
- The DIP lender typically will insist on a first-priority priming lien on the debtor's inventory, receivables, and cash (whether or not previously encumbered), a second lien on any other encumbered property, and a first-priority lien on all of the debtor's unencumbered property.
  - The grant of first lien on unencumbered assets, together with a marshalling waiver is often challenged by the creditors because, in effect, it "mops up" all value that would otherwise be available to unsecured creditors.
- A priming lien can be granted only with the consent of the secured creditors who are being primed or if the court finds that the creditors are adequately protected despite the granting of the priming DIP lien.
  - In many cases, pre-bankruptcy inventory and receivables lenders consent to being primed and to the use of their cash collateral in exchange for a package of protections specified in the court order approving the financing.
  - These protections typically include a second lien on unencumbered assets (behind the DIP loan) and, quite often, current cash payment of interest.

Collateral and Carve-Out (cont'd)

Scope of DIP Liens (cont'd)

- One reason secured lenders often consent to being primed is because the value of their collateral interest (and thus their recovery) will plummet unless new money is lent to the debtor to maintain operations and inspire vendor and customer confidence.

- **Avoidance Action Claims and Proceeds.** One often contested item of collateral has been the debtor's estate's avoidance actions under sections 547 and 548 of the Bankruptcy Code.
  - The DIP lender invariably demands a lien on such actions.
  - The creditors' committee just as invariably objects.
  - The outcome generally is that the DIP lender is granted a lien on the "proceeds" of such actions, but not the actions or the claims asserted therein themselves.

- **D&O Policies and Proceeds.** Another sometime contested matter is a demand by the DIP lender for a lien on the debtor's directors and officer's liability policies.
  - On the theory that the proceeds of such policies are not necessarily property of the debtor's estate, the debtor and/or the committee has often objected, with varying success.

Collateral and Carve-Out (cont'd)

Carve-Out

- One concession generally required from every DIP lender is a "carve-out" (the "Carve-Out") from the scope of its collateral to provide the debtor and the creditors' committee with case-administration-related liquidity in the event that the chapter 11 process fails.

- The DIP Carve-Out generally acts to protect against the downside risk to estate professionals in the event a plan is not confirmed and the estate becomes insolvent, and it is typically granted by a secured creditor in recognition of its potential exposure to surcharge of its collateral under section 506(c) of the Bankruptcy Code.
  - The Carve-Out, which only becomes relevant once a plan or sale process falls apart and the estate has no unencumbered assets to pay professionals, is often structured to provide for the payment of (i) all fees and expenses accrued and budgeted prior to an event of default or termination date; and (ii) an agreed-upon amount of fees and expenses (proportional to the size of the case) incurred after such date, allocated between the debtor's and the committee's professionals.
  - A frequent objection and/or point of negotiation is the relative sharing between the debtor and the committee in full amount of the Carve-Out.
  - The debtor often proposes a low-ball, facially token discriminatory amount to the committee, but, prior to entry of a final order, the allocation generally falls into a 70% (debtor)/30% (committee) range.

Adequate Protection

Protection for Prepetition Lenders

- Another often litigated issue relates to the scope of the collateral and liens granted to a DIP lender is the scope and type of "adequate protection" granted to any pre-chapter 11 secured lenders of the debtor.
  - The purpose of adequate protection is to ensure that prepetition secured lenders receive the security they bargained for prior to the petition date. *See In re Sonora Desert Dairy,* 2015 WL 65301, at *11 (B.A.P. 9th Cir. Jan. 15, 2015) ("In other words, adequate protection is provided to ensure that the prepetition creditor receives the value for which the creditor bargained pre-bankruptcy"); *In re Ahlers*, 794 F.2d 388, 394 (8th Cir. 1986) ("Congress intended that a debtor's offer of adequate protection should, as nearly as possible under the circumstances of the case, provide the creditor with its bargained-for rights.")
- Under section 361 of the Bankruptcy Code, existing secured lenders are entitled to adequate protection under such circumstances under the following related Bankruptcy Code provisions:
  - Section 362: Due to the secured creditor's inability to exercise its rights and remedies due to the automatic stay.
  - Section 363: Due to the use, sale or lease of property in which the secured creditor holds an interest or lien including "cash collateral."
  - Section 364: Due to a senior or equal lien to be granted in property in which the senior creditor has a lien.
- Court has flexibility to determine form of adequate protection, including the following:
  - Cash payments (*e.g.*, for attorney's fees and current interest) to compensate for depreciation or consumption of collateral.
  - Additional or replacement liens.
  - Administrative expense priority is not, in and of itself adequate protection under Section 361(3).

Adequate Protection (cont'd)

- The value of a secured creditor's collateral is often at issue in any contested claim for adequate protection.
  - If the claim is oversecured, section 506(b) of the Bankruptcy Code will entitle the secured creditor to keep any current interest and reasonable fees paid to it as adequate protection.
  - If claim turns out to be undersecured, interest and fee payments will have to be recharacterized as principal payments on the relevant secured debt, and DIP order will so provide.
- The scope of the replacement liens granted to the prepetition lenders may also be subject to dispute.
  - Prepetition lenders will seek to make these liens coextensive in scope (while junior in priority) to the liens granted to the DIP lenders
    - The liens granted to the DIP lender encompass both previously encumbered and unencumbered assets; granting the same liens to the prepetition lenders will expand the scope of the prepetition lenders' prepetition collateral.
  - The committee may object on the ground that such overly expansive replacement liens "mop up" all remaining unencumbered value, leaving no value or likely distributions for unsecured creditors, and permitting the prepetition lenders to "improve," not "preserve" their position.
    - Such improvement is prohibited by basic adequate protection principles. *See In re Pine Lake Vill. Apartment Co.*, 19 B.R. 819, 824 (Bankr. S.D.N.Y. 1982) ("Neither the legislative history nor the [Bankruptcy] Code indicate that Congress intended the concept of adequate protection to go beyond the scope of protecting the secured claim holder from a diminution in the value of the collateral securing the debt."*)*; *In re Orlando Trout Creek Ranch*, 80 B.R. 190, 191-92 (Bankr. N.D. Cal. 1987) (where value of collateral has appreciated during chapter 11 case, "[i]t would be overcompensation to ignore this benefit in computing any sort of adequate protection"); *In re Bluejay Props., LLC*, 512 B.R. 390 (B.A.P 10th Cir.. 2014) ("[A]dequate protection is intended to protect against a decline in a creditor's security cushion; it is not intended to allow a creditor to improve the security cushion that it had at the time the bankruptcy petition was filed.")

Case Controls—Generally

- In addition to DIP liens and super-priority claims, DIP lenders are typically afforded other protections to permit them a full recovery, even if the debtor liquidates. The DIP loan documents and/or the DIP order, for example, will typically provide for the following protections:
  - **Budget**. A line-item budget that dictates how and when the proceeds of the DIP loans may be used.
  - **Borrowing Base**. The budget is sometimes paired with a "borrowing base," which imposes further limitations on the use of DIP loan proceeds.
  - **Use of Proceeds**. Covenants that prohibit the use of DIP loan proceeds for specified purposes, including challenging the liens and claims of, or commencing litigation, against the DIP lender.
  - **Asset Sale Proceeds**. Covenants requiring that all asset sale proceeds be applied to reduce the DIP loans and commitments.
  - **Exercise of Remedies**. Covenants providing that upon an event of default under the DIP facility, the automatic stay is immediately modified to permit the DIP lender to exercise its remedies under the DIP credit agreement, including the foreclosure upon, and the sale of, the DIP collateral.
    - After litigation and/or negotiation with creditors' committee, this is generally modified to provide for a five (5)-business day notice period and the opportunity for any party in interest to be heard before foreclosure or sale as to DIP collateral.
  - **Primed Lender Standstill**. Covenants requiring that the primed prepetition lenders cannot exercise remedies until the DIP loans have been repaid in full.
  - **Events of Default**. Event of default mandating that certain events, such as conversion of the case to a chapter 7 liquidation or appointment of a trustee in bankruptcy, permit the DIP lender to call the loan.
  - **Credit Bidding Rights**. DIP order and credit agreement provisions permitting the DIP lender to credit bid the full face amount of the DIP loans in compliance with the requirements of section 363(k).

Milestones

- Many DIP loans, especially those from incumbent lenders or loan-to-own lenders, contain affirmative covenants known as bankruptcy "milestones."

Chapter 11 Case/Plan Milestones

- Such milestones require the debtor to satisfy certain chapter 11 case or plan objectives within a specified period of time, for example, setting deadlines for:
  - Filing a plan of reorganization;
  - Court approval of a disclosure statement;
  - Confirmation hearing; and
  - Entry of a confirmation order.

Asset Sale Milestones

- Alternatively, the DIP milestones can dictate a timetable for the sale of the debtor's assets, setting deadlines for:
  - Entry of bidding procedures order;
  - Duration of marketing process;
  - Date of auction; and
  - Sale approval hearing.

Milestones (cont'd)

Toggle Milestones

- As a final alternative, some DIP orders provide for a two-track or "toggle" timetable, which requires the debtor to pursue both plan and sale tracks simultaneously and pivot, to one or the other, at some agreed juncture.

Criticism of Milestones

- Bankruptcy milestones often impose unrealistically short deadlines that may hinder debtors from successfully reorganizing, because failure to meet these deadlines often gives the DIP lender the option to sell all of the debtor's assets.
  - Such "rocket docket" milestone timelines have generally been challenged, with some success, by creditors' committees, once appointed and organized.
  - In addition, the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 recommended, among other things, in its *Final Report and Recommendations,* that the Bankruptcy Code be amended to provide that milestones for significant actions cannot take effect within the first 60 days following the petition date.
    - Although the report has no legal effect and its recommendations are not likely to be implemented in the Bankruptcy Code for some time (if ever), this proposal is indicative of the increasing opposition to particularly restrictive milestones.
- At the end of the day, the approval of a "milestone" timeline will be controlled by a single evidentiary question: Is the debtor's business a "melting ice cube," or can its sale await conclusion of an appropriate marketing period?

Waivers

Section 506(c) Waiver

- Section 506(c) was intended by Congress to insure that a secured creditor pays the costs associated with maintaining or disposing of its collateral during a bankruptcy case. *See, e.g.*, *In re Codesco, Inc.*, 18 B.R. 225, 230 (Bankr. S.D.N.Y. 1982) ("The underlying rationale for charging a lienholder with the costs and expenses of preserving or disposing of the secured collateral is that the general estate and unsecured creditors should not be required to bear the cost of protecting what is not theirs.")
  - To address this contingency, section 506(c) authorizes a debtor to surcharge a secured creditor for the "actual" and "necessary" costs of preserving, and disposing of, the secured creditor's collateral, where such collateral is shown to be at risk of decline in value. 11 U.S.C. § 506(c); *see In re Proto-Specialties, Inc.*, 43 B.R. 81, 83 (Bankr. D. Az. 1984) (section 506(c) "expresses the equitable principle [that] a lienholder may be charged with the reasonable costs and expenses incurred to preserve or dispose of collateral, to the extent the secured party is benefited").
- DIP Lenders invariably demand, and generally demand section 506(c) Waivers.
  - Counterargument is that section 506(c) waiver should be denied if there is any possibility that the waiver will result in a "windfall" to the DIP lender. *See, e.g.*, *Hartford Fire Ins. Co. v. Norwest Bank Minn., N.A. (In re Lockwood Corp.)*, 223 B.R. 170, 176 (B.A.P. 8th Cir. 1998) (holding that provision in DIP financing order purporting to immunize lender from Bankruptcy Code section 506(c) surcharges was unenforceable and would create an improper windfall); *In re Colad Grp.*, 324 B.R. 208, 224 (W.D.N.Y. 2005) (refusing to approve DIP financing with a section 506(c) waiver intact); *In re Brown Bros.*, 136 B.R. 470, 474 (W.D. Mich. 1991) (concluding that a Bankruptcy Code section 506(c) waiver "is not enforceable in light of the congressional mandate that a trustee have the authority to use a portion of secured collateral for its preservation or proper disposal").

Waivers (cont'd)

Section 552(b) Waiver

- Section 552(b) provides that "if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case . . . *except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.*" 11 U.S.C. § 552(b) (emphasis added).
  - The purpose of the Section 552(b) "equities of the case" exception (as reflected in language of section 552(b) highlighted above) is "to prevent a secured creditor from reaping benefits from collateral that has appreciated in value as a result of the trustee's/debtor-in-possession's use [*i.e.*, including the value of any services rendered or labor performed by the debtor in connection therewith] of the of other estate assets (which normally would go to general creditors) to cause the appreciated value." *In re Muma Servs.*, 322 B.R. 541, 558-59 (Bankr. D. Del. 2008).
- DIP Lenders invariably demand, and generally obtain, section 552(b) waivers.
  - Counterargument more often than not is that waiving the equities of the case exception in early days of chapter 11 case would be premature. The Court cannot possibly determine the "equities of the case" only weeks after the petition date, or order the elimination today of a remedy that could be based on the "equities of the case" tomorrow.
  - Thus, any finding of fact that prospectively waive the "equities of the case" exception set forth in section 552(b) is premature. *See, e.g.*, *Sprint Nextel Corp. v. U.S. Bank Nat'l Ass'n (In re TerreStar Networks, Inc.)*, 457 B.R. 254, 272-73 (Bankr. S.D.N.Y. 2011) (denying request for 552(b) waiver as premature because factual record was not fully developed); *In re Metaldyne Corp.*, 2009 WL 2883045, at *6 (Bankr. S.D.N.Y. June 23, 2009) (declining to waive equities of the case exception in connection with approval of debtor's use of cash collateral).

Waivers (cont'd)

Waiver of Marshaling Principles

- The equitable doctrine of marshaling requires a secured creditor to first seek recovery from assets against which other creditors do not have a claim before looking to common assets.
  - Marshaling "prevent[s] the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security." *Meyer v. United States*, 375 U.S. 233, 237 (1963).
- DIP Lenders invariably demand, and generally obtain, waivers of marshaling rights.
  - Creditors' committees often oppose such waivers on the ground that the committee, as the representative of the chapter 11 estate, can assert equitable marshaling rights against secured creditors, for the benefit of unsecured creditors by virtue of the powers granted to the debtor by section 544(a) of the Bankruptcy Code. *See, e.g.*, *Owens-Corning Fiberglas Corp. v. Ctr. Wholesale, Inc. (In re Ctr. Wholesale, Inc.)*, 759 F.2d 1440, 1446 (9th Cir. 1985); *United States v. Houghton (In re Szwyd)*, 408 B.R. 547, 550 (D. Mass. 2009); *Kittay v. Atl. Bank (In re Global Serv. Grp. LLC)*, 316 B.R. 451, 463 (Bankr. S.D.N.Y. 2004).
    - Thus, any proposed categorical waiver of marshaling rights would adversely affect both the debtor's and the unsecured creditor's rights in chapter 11 cases.
  - DIP lenders, in turn, argue that marshaling is an equitable doctrine that exists solely for the benefit of a debtor's secured creditors, not its unsecured claimants. *See In re Advanced Mktg. Servs., Inc.*, 360 B.R. 421, 427 (Bankr. D. Del. 2007) (Sontchi, J.) ("'[U]nsecured creditors cannot invoke the equitable doctrine of marshaling.'") (quoting *Yenkin-Majestic Paint Corp. v. Wheeling–Pittsburgh Steel Corp. (In re Pittsburgh-Canfield Corp.)*, 309 B.R. 277, 283–88 (B.A.P. 6th Cir.2004)). According to secured creditors, unsecured creditors and creditors' committees have no standing to invoke the doctrine of marshaling. *See In re Gibson Group, Inc.*, 151 B.R. 133, 134-35 (Bankr. S.D. Ohio 1993) (denying unsecured creditors' committee standing to seek marshaling).

Roll-Ups

- Where the prepetition secured lenders become a source of DIP financing, such lenders may seek to "roll-up" their prepetition loans into DIP financing loans.
  - If a court authorizes a roll-up, all or part of prepetition indebtedness is "rolled" into and repaid by (or deemed to be repaid by) an equivalent participation in the DIP facility.
    - Often only a portion of the DIP loan is new money (with the balance being comprised of a roll-up of funds used to repay the prepetition debt), keeping the debtor operating just long enough to liquidate the lenders' collateral.
  - A roll-up improves the priority position of the prepetition debt.
    - Moreover, as DIP facility claims, such rolled-up claims must be paid in full in cash if a reorganization plan is to be confirmed, thereby eliminating any cramdown risk.
  - Roll-ups typically take one of two forms:
    - A *pro rata* roll-up allows each lender to roll up an amount proportionate to its share of the prepetition loan, regardless of whether such lender provides any new money as part of the DIP financing
    - A "dollar-for-dollar" roll-up only applies to those prepetition lenders that extend new money; those lenders that do not provide new capital do not receive the benefits of the roll-up.
      - Most roll-ups have been structured as dollar-for-dollar roll-ups to incentivize lenders to fund large amounts of new capital.

Roll-Ups (cont'd)

- Some roll-up tranches have also been structured to convert to post-emergence debt obligations of the reorganized company, subject to the satisfaction of various conditions, rather than being repaid in full in cash at the end of the bankruptcy case.
  - Lyondell's $8 billion DIP loan and Kodak's $830 million junior DIP loan are examples of this modified type of roll-up.
  - Notably, the ABI Commission's *Final Report and Recommendations* proposed that a court should not approve postpetition financings that contain a roll-up of prepetition debt or will be used to pay down prepetition debt unless the financing is in the best interest of the estate and either: is provided by new lenders; or offers substantial new money and better terms than alternative facilities offered to the debtor.
- Nonetheless, roll-ups featuring a repayment of some or all of the debtor's prepetition secured obligations are routinely approved in the Southern District of New York, the District of Delaware, and other jurisdictions.
  - The list is long and growing. *See, e.g.*, *In re Sears Holding Corporation*, Case No. 18-23538 (RDD) (Bankr. S.D.N.Y. Nov. 27, 2018) (approving a $1.85 billion senior secured DIP facility with a $1.53 billion roll-up—a 5.1:1 roll-up to new money ratio); *In re Cenveo*, Case No. 18-22178 (RDD) (Bankr. S.D.N.Y. Feb. 6, 2018) (approving DIP financing consisting of a $190 million roll-up and $100 million in new money; a 1.9:1 roll-up to new money ratio); *In re Angelica Corporation*, Case No. 17-10870 (JLH) (Bankr. S.D.N.Y. May 3, 2017) (approving DIP financing consisting of a $50.5 million roll-up with $14.5 million of new money; a 3.5:1 roll-up to new money ratio); *In re The Bon-Ton Stores, Inc.*, No. 18-10248 (Bankr. D. Del. Feb. 6, 2018) (approving DIP financing consisting of a $493 million roll-up and $232 of new money; a 2.15:1 roll-up to new money ratio); *In re Charming Charlie*, Case No. 17-12906 (Bankr. D. Del. Dec. 13, 2017) (approving DIP financing with a $62 million roll-up and $33 million of new money; a 1.9:1 roll-up to new money ratio); *In re The Gymboree Corp.*, No. 17-32968 (Bankr. E.D. Va. June 12, 2017) (approving DIP financing, comprising a $70 million roll-up and $35 million of new money; a 2:1 roll-up to new money ratio); *In re iHeartMedia*, Case No. 18-31274 (MI) (Bankr. S.D.Tex. June 7, 2018) (approving DIP financing with a $371 million roll-up and $79 million of new money; a 4.7:1 roll-up to new money ratio); *In re VER Technologies Holdco LLC*, Case No. 18-10834 (KG) (Bankr. D. Del. May 4, 2018) (approving DIP financing with a $310 million roll-up and $54 million of new money; a 5.7:1 roll-up to new money ratio).

Roll-Ups (cont'd)

- However, roll-ups continue to be one of the most controversial aspects of DIP financing. Bankruptcy court approval of a roll-up, particularly at a "first-day" hearing, is never a sure thing.
- With this general caveat, roll-up DIPs have, to one or extent or another, been approved at first-day hearings on a variety of rationales.
  - In *In re Aegean Marine Petroleum Network Inc.,* Case No. 18-13374 (Bankr. S.D.N.Y. Nov. 11, 2019), for example, Judge Bernstein was not willing to approve (i) the immediate roll-up of 50% of prepetition ABL obligations upon entry of the interim order; or (ii) language in the interim order mandating that "upon entry of the Final Order, all outstanding Prepetition ABL Obligations shall become DIP Obligations[.]" However, he did authorize the "creeping roll-up" of the prepetition ABL obligations between entry of the interim order and entry of the final order with respect to cash proceeds of priority collateral securing the prepetition ABL obligations.
  - In *In re Remington Outdoor Company, Inc., et al.* Case No. 18-10684 (BLS) (Bankr. D. Del. Mr. 26, 2018), Judge Shannon approved, on the first day with respect to a prepack plan, the rollup aspects of both a $45 million prepetition rescue bridge financing and the prepetition portion of the $193 million DIP ABL of about $114.5 million, on the ground that "prepacks are different; not that roll-ups are appropriate or welcome in a first day in any or every prepack, but I approach a prepack differently than I would a typical Chapter 11, given the amount of legwork and coordination that is reflected in the prepetition work and in the balloting process that has occurred on a prepetition basis in a routine prepetition, and specifically in this case."
  - Other recent chapter 11 case in which roll-ups, of one type or another, have approved at the first-day hearing include the following:
    - *In re The Bon-Ton Stores, Inc.*, No. 18-10248 (Bankr. D. Del. Feb. 6, 2018) (approving on interim order "roll-up" of all outstanding prepetition revolving obligations).
    - *In re Charming Charlie Holdings Inc.*, No. 17-12906 (Bankr. D. Del. Dec. 13, 2017) (approving on interim order "roll-up" of all outstanding prepetition revolving obligations).

Roll-Ups (cont'd)

- *In re The Gymboree Corp.*, No. 17-32968 (Bankr. E.D. Va. Jun. 12, 2017) (approving on interim order "roll-up" of all outstanding prepetition revolving obligations).
- *In re rue21,Inc.*, No. 17-22045 (Bankr. W.D. Pa. May 18, 2017) (approving on interim order "roll-up" of all outstanding prepetition revolving obligations).
- *In re BCBG Max Azria Holdings, LLC*, No. 17-10466 (Bankr. S.D.N.Y. Mar. 2, 2017) (approving "roll-up of all outstanding prepetition revolving obligations).
- *In re NewPage Corp.*, No. 16-10163 (Bankr. D. Del. Jan. 27, 2016) (approving on interim order "roll up" of all outstanding prepetition ABL obligations).
- *In re American Apparel, Inc.*, No. 15-12055 (Bankr. D. Del. Oct. 6, 2015) (approving repayment in full of all outstanding amounts under the prepetition revolving credit agreement).

Judicial Oversight

- Bankruptcy courts exercise substantial control over, and discretion with respect to, the approval of DIP financings, especially on an interim basis in the First-Day Hearing context.
- Underlying the steady hand that courts maintain in this regard are two competing policies.
  - On the one hand, bankruptcy courts routinely defer to a debtor's business judgment in considering whether to approve a debtor's request to obtain postpetition financing. *See, e.g.*, *In re United States Mineral Prods. Co.*, Case No. 01-2471 (JFK), 2005 WL 5887218, at *2 (Bankr. D. Del. Nov. 29, 2005) (approving financing based on debtor's and trustee's exercise of "prudent business judgment"); *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 40 (Bankr. S.D.N.Y. 1990) (holding that court should defer to debtor's "reasonable business judgment"); *In re Los Angeles Dodgers LLC*, 457 B.R. 308, 313 (Bankr. D. Del. 2011) ("]C]ourts will almost always defer to the business judgment of a debtor in the selection of the lender. . . . Under the [Business Judgment Rule], courts will not second-guess a business decision, so long as corporate management exercised a minimum level of care in arriving at the decision.").
  - On the other hand is a concern about affording secured lenders unwarranted control over the course of chapter 11 cases and permitting them to improperly usurp the mandated roles of the court, the debtors, and any committee in the chapter 11 process. *See, e.g.*, *In re Tenney Vill. Co., Inc.*, 104 B.R. 564, 568 (Bankr. S.D.N.Y. 1989) (debtor-in-possession financing terms must not "pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit" of the secured creditor; to do so would permit secured creditors to "run roughshod over numerous sections of the Bankruptcy Code"); *Gen. Elec. Capital Corp. v. Hoerner (In re Grand Valley Sport & Marine, Inc.)*, 143 B.R. 840, 852 (Bankr. W.D. Mich. 1992) ("[T]his court will not authorize post-petition financing pursuant to § 364 where a creditor leverages a debtor in possession into making a concession unauthorized by, or in conflict with, the Bankruptcy Code as a condition for the requested credit"); *In re Berry Good, LLC*, 400 B.R. 741, 747 (Bankr. D. Ariz. 2008) ("[B]ankruptcy courts do not allow terms in financing arrangements which convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the post-petition lender").

Judicial Oversight (cont'd)

  - Also in play is Bankruptcy Rule 4001(c)(2)'s dictate that the bankruptcy court "may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing." Fed. R. Bankr. P. 4001(c)(2).
- The middle course that court have generally steered as a result of all the foregoing has been to subject the proposed DIP financing to strict scrutiny at the interim stage, but (subject to objections by the creditors' committee and others) to afford more deference to its terms at the final approval stage.
  - At the First Day Hearing, bankruptcy courts have worked with the U.S. Trustee and any *ad hoc* committees that are already on the scene to defer, and to preserve for review and objection by, the official creditor's committee when appointed, any contentious issues with likely long-lasting effects, including (i) the full amount of the DIP loans, (ii) some or all of any proposed roll-up; (iii) any sale or plan milestones; (iv) the amount of the Carve-Out; (v) the duration of the creditors committee's investigation period; (vi) any right by the DIP lender or prepetition lenders to credit bid on debtor assets; and (vi) any waivers of section 506(c), section 552(b), and/or marshaling principles.
- Courts also police, and potentially reject, DIP order provisions and protections relating to (i) detailed findings of fact that may be unsupported by the evidentiary record; and (ii) over-expansive releases and exculpations granted to lenders and other key parties in interest.
  - Another focus for many bankruptcy courts has been the length and scope of DIP orders. As financings have grown more complex, and counsel more diligent in their efforts to protect relevant rights, DIP orders have grown longer and more complex, in some cases exceeding 100 pages. A number of bankruptcy judges have pushed back, urging brevity, concision, and a scope no more expansive than required to obtain a straightforward judicial blessing for rights that are more fully set forth in the DIP credit agreement and related documents.

Roll of Committees

- Committees representing creditors, both *ad hoc* and official committees, play a significant role in both the interim and final approvals of DIP financings.
  - An "official" creditor's committee is typically not appointed until a few days (or, in some jurisdictions, a week or more) after conclusion of the "first-day hearing" in most chapter 11 cases. Hence, neither its members nor its counsel is actually present at such hearings, but its soon-to-be arrival cast a large shadow over such hearings.
- The court, as set forth above, will work with the U.S. Trustee and any *ad hoc* committees already on the scene to defer and preserve for the official committee key issues.
  - On a global basis, the official committee, once appointed, will want to (i) confirm that the DIP facility is appropriately "sized" (*i.e.*, the debtor is not incurring more DIP debt than it requires, thereby diluting ultimate unsecured creditor recoveries); (ii) the interest rates, fees, and other financial elements are "market"; and (iii) there is not an alternative DIP facility, with more favorable terms, available to the debtors.
  - The final consideration will generally prompt the committee to demand more time prior to final approval to "shop" the DIP facility. This will sometimes result in the identification of an alternative DIP facility, but just as often the debtor will resist and argue that if final approval is not obtained on the stipulated timetable, liquidation will follow.
- The creditors' committee's DIP facility-related concerns generally revolve around ensuring its ability to pursue claims and enhance recoveries for its constituency, relating to, among other things, the following:
  - **Budget and Carve-Out**. The committee will seek to ensure that the proposed DIP budget line item amounts for its advisors are sufficient to fund its activities; and (ii) the amount of the Carve-Out allocated to the creditors' committee is adequate and proportional to the amount allocated to the debtor.
    - However, even if the DIP order and/or the budget succeed in capping the committee's budget or carveout fee amounts at a level acceptable to the secured lender, that may not be the end of the story, as demonstrated recently in *In re Molycorp., Inc.*, Case No. 15-11357 (CSS) (Bankr. D. Del. Jan. 5, 2017).

Roll of Committees (cont'd)

- The question before Judge Sontchi in *Molycorp* was whether the carve-out served as a hard cap on fees. Molycorp, following months of hostility between the official creditors' committee and its secured lender, succeeded in confirming a plan of reorganization.
  - The secured lender early in the case had consented to a carveout of no more than $250,000. In the end, the committee sought payment of nearly $8 million in fees and expenses for its counsel.
- The secured lender objected, arguing that the only source of funds were from its collateral, and that because the proceeds of its collateral could not be used without its consent, the fees of the committee's professionals were capped.
- Conversely, the committee relied on Section 1129(a)(9) of the Bankruptcy Code.
  - Among the requirements which must be met when a plan of reorganization is confirmed is that all administrative claims (*i.e.*, claims incurred during the bankruptcy case that were necessary for the administration of the debtor's bankruptcy estate) must be paid in full.
  - The committee argued that once Molycorp's plan was confirmed, Section 1129(a)(9) controlled and that the carve-out in the financing order was no longer operative
- The secured lender responded by noting that Section 1129(a)(9) provides that the holder of an administrative claim may agree to accept less than full payment.
  - In its view, the carve-out had effectively served as such an agreement.
- Judge Sontchi sided with the creditors' committee.
  - He determined that the carveout in the financing order could not limit the payment of committee counsel's fees as administrative expenses under a confirmed plan of reorganization.
  - He stated that the payment of administrative expenses under Section 1129(a)(9) is "a fundamental statutory requirement of the Bankruptcy Code."

Roll of Committees (cont'd)

- **Investigation Period and Budget**. Enhancement of unsecured creditor recoveries will often turn on the creditors' committee's ability to identify (i) debtor assets that are not encumbered by properly perfected liens; and (ii) claims that the debtor's estate may have against its pre-bankruptcy lenders and management.
  - Such matters are generally waived by the debtor unless the committee can, within a specified period of time and with a limited budget, identify such assets and claims.
  - The length of the investigation period and the amount of the investigation budget are vigorously contested, with the debtor/DIP lender lowballing the committee and litigation/negotiation resulting in a mutually acceptable time period and budget number
- **Estate Assets**. Just as the DIP lender will push for inclusion in the DIP collateral of gray-areas assets such as avoidance actions and D&O policies, the committee will resist, seeking to preserve these and any other assets to which the post-chapter 11 estate may have paramount title for the unsecured creditors.
- **Credit Bidding Rights**. The creditors' committee will also seek to ensure that neither the DIP lender nor the prepetition lenders are granted in the DIP order, or elsewhere, the right to credit bid as to the debtor's assets until the scope, validity and amount of lenders' liens and claims have been established by the creditor's committee investigation.
- **Waivers**. Finally, the creditor's committee will object to the inclusion in the DIP order of any of the waivers typically demanded by DIP lenders, as to section 506(c), section 552(b), or as to marshaling principles, on the ground, as set forth above, that waivers of such protections will materially impair unsecured creditor recoveries, especially where, as is often the case recently, the chapter 11 case is largely conducted to liquidate the collateral, and thus for the benefit, of the prepetition lenders.

First Day Do's and Don'ts: Survey of Recent DIP Facility Terms

Recent DIP Market Terms

- The DIP market is an active credit market which can be bifurcated into (i) highly situational middle market DIP loans provided by alternative capital providers and (ii) larger syndicated credit facilities supplied by money center commercial lenders.
  - Not surprisingly, the majority of recent cases have been in Retail, Energy and Healthcare.
- DIP loans provided by alternative capital providers such as hedge funds, specialty lenders, stalking-horse bidders and pre-petition lenders tend to have a higher "All-In" interest rate.
  - In the last 6 months, DIPs priced by alternative capital providers averaged an "All-In" Interest Rate of ~12.53%.
- DIP loans that are larger are typically provided by large money center commercial banks such as Bank of America, JPMorgan and Wells Fargo, who are typically prepetition revolver and term lenders.
  - The larger the case, the more liquid the loans are, with greater institutional acceptance of the risk and a closer relationship with the enterprise.
  - In the last 6 months, DIPs provided by commercial banks averaged an "All-In" Interest Rate of ~9.60%.
- While the post-Great Recession DIP market has largely stabilized, in recent times, we have seen more structuring around original issue discounts and various fees increasing the "All-In" interest rate that Chapter 11 debtors are paying.
  - *Fee enhancements include, but are not limited to, Closing Fee, Fronting Fee, Exit Fee, Restructuring Fee, Commitment Fee, Structuring Fee, Origination Fee and Backstop Fee.*

Summary of Recent DIP Loans: Alternative Providers

DIP Facilities > $10mm Last 6 Months
($ in 000s)

Debtor	Lender(s)	Sector	Total	Term	Interest Rate	"All In" Rate
Taco Bueno Restaurants	Taco Supremo	Consumer Discretionary	$10,000,000	4 months	7.00%	7.00%
Orchids Paper Products Company	Orchids Investment LLC	Materials	$11,000,000	6 months	12.00%	12.00%
PGHC Holdings	WC Financeco A LLC	Consumer Discretionary	$13,800,000	120 days	Prime + 3%	8.50%
Innovative Mattress Solutions	Tempur World LLC	Consumer Discretionary	$14,000,000	120 days	LIBOR + 10%	12.50%
Magnum Construction Management	Travelers Casualty and Surety Company of America Berkshire Hathaway Specialty Insurance Company	Industrials	$16,800,000	120 days	Prime rate + 1%	6.50%
Dixie Electric	Contrarian Capital Management, L.L.C. ING Capital LLC Mudrick Capital Management L.P Bank of America, N.A. ParFour Investment Management, LLC Partners Group Private Markets Credit Strategies S.A.	Energy	$17,500,000	3 months	LIBOR + 10% payable monthly in cash	16.00%
Fairway Energy	Riverstone Credit Partners-Direct	Energy	$20,000,000	150 days	LIBOR + 15%	20.00%
Welded Construction L.P.	North American Pipeline Equipment Company	Energy	$20,000,000	180 days	10.00%	10.00%
Double Jump	B.H. Capital Ventures, LLC	Technology	$20,500,000	12 months	12.00%	12.00%
Payless Inc.	Axar Capital Management Citibank Invesco High Yield Municipal Fund Benefit Street Octagon	Consumer Discretionary	$25,000,000	7 months	LIBOR + 8%	12.00%
Sorenson Media	JLS Holdings LLC	Technology	$26,500,000	Dec. 31 2018	5.00%	5.00%
Pernix	1992 MSF International Ltd. 1992 Tactical Credit Master Fund	Health Care	$34,100,000	180 days	LIBOR + 6%	8.50%
LBI Media	HPS Investment Partners, LLC	Consumer Discretionary	$38,000,000	180 days	Base Rate + 8% or 3-month Eurocurrency rate + 9%	16.00%
Waypoint Leasing Holdings Ltd.	Pre-petition WAC Lenders	Consumer Discretionary	$45,000,000	30 days	LIBOR + 7.5% (1% LIBOR Floor)	14.00%
Trident Holding Company	SPCP Group	Consumer Discretionary	$50,000,000	180 days	base rate + 7% or LIBOR + 8%	12.50%
Gymboree Group Inc.	Special Situations Investing Group	Consumer Discretionary	$119,000,000	210 days	Tranche A: L + 8.25% Tranche B: L + 11.25% both subject to a 2% LIBOR floor	12.75% - 15.75%
Synergy Pharmaceuticals	CRG Partners	Health Care	$155,000,000	120 days	LIBOR + 9.5%	17.00%
Mission Coal Company	MC Southwork LLC Coal Specialty Funding, LLC	Energy	$202,900,000	180 days	LIBOR+9.75% (subject to a 1% floor) if paid in cash or L+12% (subject to a 1% floor) if PIK	16.25% - 18.50%
Southcross Energy Partners L.P.	Solus Alternative Asset Management LP Sound Point Capital Management LP	Energy	$255,000,000	6 months	alternate base rate + 9% or LIBOR + 10%; alternate base rate + 5.25% for rollup loans	17.00%

"All-in" Rate includes OID and all associated fees such as upfront fee, commitment fee and exit Fee
Assumes Prime Rate is 5.50% and LIBOR is 2.5%

Summary of Recent DIP Loans: Commercial Providers

DIP Facilities > $10mm Last 6 Months
($ in 000s)

Debtor	Lender(s)	Sector	Total	Term	Interest Rate	"All In" Rate
Z Gallerie LLC	KeyBank	Consumer Discretionary	$28,000,000	120 days	LIBOR + 7.75% or Base Rate + 4.25%	14.25%
Charlotte Russe	Bank of America	Energy	$50,000,000	4 months	Alternate base rate + 2.5% or LIBOR + 3.5%	7.50%
Aceto Corporation	Wells Fargo Bank JPMorgan Chase Bank TD Bank Citibank Citizens Bank Santander Bank Bank Leumi USA BMO Harris Bank HSBC Bank USA	Health Care	$60,000,000	108 days	alternate base rate + 6% or adj. LIBOR + 7%	11.50%
Promise Healthcare Group	Wells Fargo Bank	Health Care	$85,000,000	180 days	Revolving Loans: Base Rate + 4% Term Loan: Base Rate + 4.25%	7.00%
CTI Foods Holding Co.	Barclays Bank PLC Wells Fargo Bank	Consumer Staples	$155,000,000	120 days	Term loan: base rate + 7% or L + 8%; ABL: L+3.5% or base rate + 2.5%	ABL: 6% Term Loan: 9.5%
David's Bridal Inc.	Bank of America Morgan Stanley Barclays Bank PLC Goldman Sachs and Co. LLC Credit Suisse AG Deutsche Bank	Consumer Discretionary	$185,000,000	180 days	ABL: LIBOR + 3% Term: LIBOR + 7.5% both subject to 1% LIBOR floor	ABL: 8.875% Term Loan: 14.0%
Shopko	Wells Fargo Bank PNC Bank CIT Bank Bank of America Citizens Business Capital Bank of Montreal TD Bank JPMorgan Chase Bank US Bank Gordon Brothers Finance	Consumer Discretionary	$480,000,000	one year	prime rate + i) 2.75% for revolving loans A ii) 4% for revolving loans A-1 iii) 9.5% for term loans B iv) 14% for term loans B-1	Revlover A: 8.25% Revolver A-1: 9.50% Term Loan B: 15.0% Term Loan B-1: 19.5%
Sears Holdings Corporation	Bank of America Wells Fargo Bank National Association Citibank	Consumer Discretionary	$1,830,000,000	12 months	ABL Revolver: base rate + 3.5% or LIBOR + 4.5%; ABL TL: LIBOR + 8%	ABL: 7.0% Term: 10.50%
PG&E Corporation	JPMorgan Chase Bank Bank of America Barclays Bank PLC Citibank BNP Paribas Credit Suisse AG Goldman Sachs Bank USA MUFG Union Bank Wells Fargo Bank, National	Utilities	$5,500,000,000	23 months	Revolving facility: L + 2.25%; all term loans: L + 2.5%	Revolver: 5.25% Term Loan: 5.5%

"All -n" Rate includes OID and all associated fees such as upfront fee, commitment fee and exit Fee
Assumes Prime Rate is 5.50% and LIBOR is 2.5%

Alternative DIPS: Pricing, Priming, and Stepping into Shoes of Initial DIP Lender

Alternative DIPs

- As set forth above, due to pressing cash needs, a debtor will generally seek all the relief it needs—or that it believes it can obtain—at the First Day Hearing. This will sometimes mean that the relief that the debtor seeks, including with respect to the DIP facility it proposes to utilize, is not all that it wanted or all that can ultimately be obtained. The clock simply ran out and the debtor filed with the DIP facility then in hand.
  - As a result, in the period between "interim" approval of the DIP facility at the First Day Hearing and its "final" approval two to three weeks (or more) later, there is often an opening for consideration, and potential adoption, of alternative DIP proposals.
  - The debtor itself and its financial advisor may be the prime mover, potentially acting with the renewed cooperation of lenders who came to the table too late and/or could not get to closure on terms prior to the petition date.
  - More likely, it will be the creditors' committee, along with its financial advisor, that will be out beating the bushes for competing DIP lenders. Indeed, if the official committee is unhappy with the DIP facility's terms and contemplating an objection, its objection will be made materially more compelling if it can identify and bring to the table a lender offering better terms.
  - A final pool of potential alternative lenders might be found among the members of the incumbent lender group or in the overtures of a strategic player, whose interest has been belatedly whetted by the chapter 11 filing and the opportunities for control that a DIP loan will create.

Alternative DIPs (cont'd)

- With prospects identified, the key component of a viable alternative bid will generally include:
  - ***Lower Interest Rates***
    - Better baseline economics critical to the success of any alternative bid.
    - Debtor and lender FA to work together to arrive at compelling rate package.
  - ***Lower Fees***
    - The fewer the better.
    - Lower and less onerous.
    - No outliers like break-up fees or make-whole premiums.
  - **Less Restrictive Terms**
    - Fewer and less onerous covenants.
    - Carve-Out amounts, liens and waivers retooled.

Alternative DIPs (cont'd)

- ***More Flexible Milestones***
  - Engender optionality by creating longer chapter 11 plan runway.
  - Work with creditors' committee to replace sale with plan objectives.
- ***Ability to Step Into Shoes of Initial DIP Lender***
  - New lender must be prepared to "step into the shoes" of the initial DIP lender.
  - Expedited timeline does not allocate substantial time for renegotiation of credit documentation.
  - Explore viability of assuming exiting lender collateral package documentation.
- ***Appetite for Litigation***
  - Prospective lender must be prepared to litigate, on its own and with the debtor and/or creditors' committee to push its agenda.
  - Briefing, deposition, and trial testimony all likely.
- ***Examples of Alternative DIPs (Attempted and Successful)***
  - *In re Aegean Marine Petroleum Network Inc.*, Case No. 18-13374 (MEW), ECF No. 290 (Bankr. S.D.N.Y. Jan. 14, 2019);

Alternative DIPs (cont'd)

- *In re Grede Foundries*, Case No. 09-14337(RM), ECF N. 101 (Bankr. W.D. Wis. Jul. 2, 2009);
- *In re Solar Trust of America*, Case No. 12-11136 (KG), ECF NO. 150 (Bankr. D. Del. April 26, 2012).

Alternative DIPs: "Priming" DIP Example

- Green Field Energy Services Inc., et al. ("Debtors" or the "Company") filed for chapter 11 bankruptcy protection in the District of Delaware on October 27, 2013. The Company was a well service provider specializing in turbine powered hydraulic fracturing services. The ultimate case resolution was a liquidating Plan of Reorganization with funds provided by Gordon Brothers Group.
- The Company's Prepetition debt consisted of:
  - $80 million credit facility from Shell;
  - $255.9 million on the 13% senior secured notes due 2016; and
  - $98.6 million in trade debt.
- In the Prepetition period, certain 2016 Noteholders proposed DIP terms that were materially off-market. The Debtors had limited ability to obtain better terms from the Noteholders.
- Pursuant to a successful prepetition consent solicitation to modify certain terms in the bond indenture, the Company was permitted to incur a one-time borrowing with grantable permitted liens senior to the Noteholders in an amount up to $30 million. The Debtors utilized this provision to obtain alternative priming DIP proposals with dramatically improved pricing (L+10%).
- After drawn out negotiations, GB Credit Partners, an affiliate of Gordon Brothers, and ICON Capital agreed to provide a $30mm super-priority DIP term loan for working capital and general corporate purposes under the terms summarized on the following slide.
- Upon seeing these terms, the 2016 Noteholders agreed to the priming GB/ICON DIP financing. The third-party DIP was one of the keys that allowed the Debtors to exit bankruptcy with a consensual Plan of Reorganization supported by Shell, the Noteholders and the UCC.

DIP Financing Summary

- Ad Hoc Noteholders Committee controlled DIP milestones
- The Court approved the Final DIP Order on November 26, 2013

TERM	DESCRIPTION
DIP Credit Agreement Parties	▪ **Borrowers:** Green Field Energy Services, Inc., Hub City Tools, Inc. and Proppant One, Inc. ▪ **Lenders:** GB Credit Partners, LLC, ICON Capital LLC
DIP Commitments	▪ $30 million
Ranking / Priority	▪ Perfected first-priority priming liens on and security interest in Prepetition Shell Credit Collateral and the Indenture Collateral

Interest Rates and Fees	▪ **Contract Rate:** LIBOR plus 10.00%
	▪ **Default Rate:** Additional 3%
	▪ **Fees:**
	  ▪ **OID**: $600,000
	  ▪ **Monthly administrative fee:** $25,000 / month
	  ▪ **Make whole fee**: 2.5%

Maturity	▪ 9 months
Adequate Protection	▪ Certain milestones in the Final DIP Order for the benefit of Ad Hoc Noteholders' Committee ▪ Noteholders' liens ▪ One time $200,000 payment for reasonable professional fees ▪ Certain information sharing procedures
Milestones	Ad Hoc Noteholders Committee can declare default if following milestones are not met, subject to 4-days notice to UCC: ▪ Restructuring Support Agreement with majority of senior noteholders by Dec. 5 ▪ Restructuring agreement with Shell by Dec. 19 ▪ Motion to approve the restructuring agreement by Dec. 31 ▪ Court approval of restructuring agreement by Jan. 31 ▪ Letters of intent due by Jan 24 ▪ Sales motion by Feb. 24 ▪ Auction by March 21 ▪ Sale by April 11

Source: DIP Motion (Doc 11), Interim Order (Doc 62) and Final Order (Doc 191)

Credit Bidding: Lender Rights, Valuation, and Permissible Consideration

Credit Bidding: Limitation for Cause

Credit Bidding—Limitation for Cause

- Section 363 of the Bankruptcy Code permits a debtor to sell all or substantially all of its assets free and clear of all liens. This provision, likewise, permits a holder of an allowed secured claim against a debtor to credit bid its loans in a Section 363 Sale, unless a court, for "cause," orders otherwise.
- Prior to 2014, the bankruptcy courts had generally limited "cause" to situations in which a secured creditor had engaged in egregious misconduct (*i.e.*, such as collusion) and were largely unsympathetic to arguments that credit bidding should be precluded because it would chill the bidding process.
  - However, two 2014 bankruptcy court decisions, one from the District of Delaware and the other from the Eastern District of Virginia — *In re Free Lance-Star Publishing Co. of Fredericksburg, Va.*, 512 B.R. 798 (Bankr. E.D. Va. 2014) and *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014)—raised serious concerns among secured lenders about the continuing viability of their credit bit rights.
  - In *Free Lance-Star*, the secured creditor had purchased an existing $50.8 million loan to the debtor.
    - The debtor commenced a section 363 sale process, and the secured creditor attempted to credit bid its $38 million secured claim against the debtor.
    - Upon objection by the debtor and the creditors committee, the bankruptcy court entered an order limiting the secured creditor's right to credit bid to $13.9 million.
    - In so doing, the bankruptcy court concluded that "[t]he confluence of (i) [the secured creditor's] less than fully secured lien status; (ii) [its] overly zealous loan-to-own strategy; and (iii) the negative impact of [its] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [its] credit bid rights. "
  - Similarly, in *Fisker Automotive*, the bankruptcy court limited a secured creditor's right to credit bid its $169 million secured claim to the $25 million that the secured creditor paid for its claim.

Credit Bidding—Limitation for Cause (cont'd)

    - The bankruptcy court found that cause existed to limit the secured creditor's rights due to (i) the desire not to chill bidding at the section 363 sale; and (ii) concerns raised by unsecured creditors regarding the extent and validity of the secured creditor's liens on certain assets being sold.
- *Free Lance-Star* and *Fisker Automotive* went where other precedent had not gone before by interpreting "cause" under Section 363(k) of the Bankruptcy Code to include situations where a court has determined that capping a credit bid would foster a "robust," "competitive" and "open" sale process and found a "loan-to-own" investment strategy by a secured creditor suspect
  - Courts had previously limited "cause" to clearly egregious conduct by a lender and not just the fact that credit bidding could chill bidding in the Section 363 sale process.

Credit Bidding—Limitation for Cause—*Aéropostale*

- In *In re Aéropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2018), bankruptcy judge Sean H. Lane, of the U.S. Bankruptcy Court for the Southern District of New York recently handed down a ruling that called into question the continuing validity of the of the *Fisker* and *Free-Lance Star* line of decisions, to the relief of secured lenders.
  - In that case, Judge Lane denied motions by Aéropostale, Inc. and its affiliates (collectively, "Aéropostale"), a retailer of casual apparel and accessories for children and young adults, with more than 800 stores, to, among other things, limit the lenders' ability to credit bid their secured claim in a bankruptcy sale of the company.
  - In 2013, private equity firm Sycamore Partners ("Sycamore") acquired 8 percent of Aéropostale stock through a subsidiary for approximately $54 million. One of Aéropostale's largest merchandise suppliers was TSAM (Delaware) LLC (d.b.a. MGF Sourcing US LLC) ("MGF"), a global apparel and accessory sourcing company that was indirectly owned and controlled by Sycamore.
  - Aéropostale's secured debt included a $150 million term loan extended by two Sycamore affiliates (collectively, the "Term Lenders"). A separate sourcing agreement between Aéropostale and MGF gave MGF the right to declare a "credit review period" if Aéropostale's liquidity dropped below $150 million.
  - In February 2016, MGF informed Aéropostale that the $150 million minimum liquidity threshold under the sourcing agreement had been breached and that MGF was declaring a credit review period.
- Claiming that Sycamore had forced the company into bankruptcy for the purpose of acquiring it at a discount, Aéropostale filed a motion requesting, among other things, that the court limit the Term Lenders' right to credit bid their $150 million secured claim in any sale of the company pursuant to section 363(k) of the Bankruptcy Code.

Credit Bidding—Limitation for Cause—*Aéropostale* (cont'd)

- Judge Lane denied Aéropostale's motion.
  - In so doing, Judge Lane explained that "[t]he decision of whether to deny credit bidding based on cause [under section 363(k) of the Bankruptcy Code] is within the discretion of the court," and he had found no inequitable conduct (such as "allegations of collusion, undisclosed agreements, or any other actions designed to chill the bidding or unfairly distort the sale process") which would justify limiting a credit bid by the term lenders.
  - Most importantly, Judge Lane rejected Aéropostale's argument that bidding on the sale of its assets would be chilled by the term lenders.
    - *First*, he noted, none of the cases commonly cited as a basis for limiting a credit bid involved bid chilling as the sole factor warranting such a limitation.
    - Instead, he explained, rulings such as *Free Lance-Star, Fisker*, and *Aloha Airlines* have involved other factors as well, such as a dispute regarding the validity of the secured creditor's lien or inequitable conduct.
    - *Second*, he noted, the record reflected an active interest in Aéropostale assets rather than chilled bidding.
    - *Finally*, Judge Lane contended that his conclusions were supported by the final report issued on December 8, 2014, by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11.
      - The report noted that "all credit bidding chills an auction process to some extent" and that, as a consequence, "the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k)."
- *Aéropostale* has been greeted with relief by secured lenders, particularly insofar as the ruling embraces the view that a court-imposed limitation on a lender's right to credit bid, such as was imposed in *Fisker* and *Freelance-Star*, requires something more than the possibility of bid chilling in connection with a section 363 asset sale.

Credit Bidding: Lender Bidding Group Issues

Credit Bidding—Lender Bidding Group Issues

Bidder Lending Group Conflicts

- Given that most prepetition secured debt is held not by single lenders but by groups of lenders, the prospect of such a group submitting a credit bid for a debtor's assets can raise complex intragroup issues regarding collective action consent, corporate governance, and allocation of recoveries.
  - In a simple credit bid scenario a single lender holds both the claim and the lien securing the claim.
  - In syndicated loan transactions, by contrast, each member of the syndicate holds a separate claim against the debtor, but the lien securing those claims is usually held by a collateral or administrative agent for the benefit of all members of the syndicate.
  - This does not mean, however, that only the agent can present a credit bid. Instead, each lender, as a holder of a claim, can present a credit bid in the amount of the claim that it holds.
- A number of recent Bankruptcy Court decisions have confirmed that, although the right to credit bid belongs to the individual lender, the collateral agent, under appropriate circumstances, can make a credit bid in the full amount of the outstanding loan on behalf of the entire syndicate.
- In *Chrysler*, for example, the court in that case focused on the governing loan documents and concluded that when the loan documents give the agent the right to exercise remedies upon default with the consent of the majority of lenders, the agent can credit bid the full amount of the syndicated facility pursuant to the direction of the majority over an objection of minority lenders.
- A majority of the lenders under the first lien credit agreement instructed the agent to release collateral to the buyer in exchange for a cash recovery well below the par value of the debt.

Credit Bidding—Lender Bidding Group Issues (cont'd)

- The holdout lenders insisted that such action required amendment or waiver of the credit agreement (which required a unanimous vote of the lenders) and thus that the agent could not release the collateral at the direction of only a majority.

- The Second Circuit disagreed.
  - In so holding, the panel affirmed the bankruptcy court ruling, wherein Judge Arthur J. Gonzales stated: "The Court concludes that the purpose of the relevant provisions of the [credit, collateral and security agreements] is to have the Administrative Agent and Collateral Trustee act in the collective interest of the lenders.
  - Restricting enforcement to a single agent to engage in unified action for the interests of a group of lenders, based upon a majority vote, avoids chaos and prevents a single lender from being preferred over others." *In re Chrysler LLC*, 405 B.R. 84, 103 (Bankr. S.D.N.Y. 2009).

- The Second Circuit's decision in Chrysler adhered to the rationale advanced by several other bankruptcy courts in approving "drag-along" bids by agents on behalf of majority lenders, and also set the stage for subsequent endorsements of this approach.
  - In I*n re GWLS Holdings, Inc.*, 2009 Bankr. LEXIS 378 (Bankr. D. Del. Feb. 23, 2009) and *In re Metaldyne Corp.*, 409 B.R. 671 (Bankr. S.D.N.Y. 2009), Judge Peter Walsh and Judge Martin Glenn, respectively, found that language in loan documents similar to the language at issue in Chrysler permitted a majority of lenders to instruct the agent to submit a credit bid under § 363(k) on behalf of all lenders and concurrently release liens on collateral as part of that transaction.
  - Among other rationales, this authority was found under the loan documents pursuant to the agent's power to dispose or deliver the collateral on behalf of the lenders under any "applicable law," which the *GWLS* and *Metaldyne* courts determined included the Bankruptcy Code.
  - As in *Chrysler*, the courts in *GWLS* and *Metaldyne* overruled the objection of dissenting lenders, who argued that the actions of the majority lenders effected an amendment or waiver of the loan documents and thus required unanimous consent of the lenders.

Credit Bidding—Lender Bidding Group Issues (cont'd)

- The approach of relying on prepetition credit agreements was reaffirmed, with a somewhat different result, in *In re Electroglas, Inc.*, No. 09-12416 (PJW) (Bankr. D. Del. Sept. 23, 2009).
  - In *Electroglas*, Judge Walsh ruled that holders of secured notes issued by Electroglas could not bypass the indenture trustee and directly credit bid their claims at a section 363 sale of their collateral. In doing so, Judge Walsh denied two competing groups of noteholders the right to credit bid, each of which had attempted to credit bid its claims without the indenture trustee.
  - Even though one noteholder group controlled a majority of the notes, Judge Walsh held that the majority group could not force the indenture trustee to credit bid because the language of the indenture and security agreement only allowed a majority group of noteholders to prescribe procedures for the trustee's enforcement of remedies, not to direct the trustee to take substantive action.
  - Judge Walsh found that the language of the indenture provided the lenders with a right to request that the trustee take certain action to exercise remedies, such as submitting a credit bid at a sale of the collateral, but that the discretion to act belonged solely to the trustee.
    - Furthermore, it appears from Judge Walsh's opinion that the majority noteholders never formally requested that the trustee submit a credit bid.
  - Thus, *Electroglas* is consistent with *GWLS* and *Metaldyne* in that the court, guided by the terms of the prepetition credit agreement, held that only the indenture trustee under a syndicated loan facility had the authority to submit a credit bid.

Credit Bidding—Lender Bidding Group Issues (cont'd)

Treatment of Lenders Opposing Credit Bid

- A related question that has arisen in a number of other cases is what treatment must be afforded to those members of the syndicate who oppose the credit bid. The answer again lies in the governing loan documents—which, in most syndicated loan transactions, require the lenders to share recoveries on their claims on a *pro rata* basis.
  - One way to satisfy this requirement could be for the lender or group of lenders who make a successful credit bid to provide a cash paydown to the non-credit bidding lenders that would yield the same net paydown for all members of the syndicate.
- This was the approach adopted in *In re Foamex Int'l Inc.*, No. 09-10560 (KJC) (Bankr. D. Del.) and *In re Propex Inc.*, No. 08-10249 (JCC) (Bankr. E.D. Tenn.), where a majority of lenders directing the administrative agent to credit bid funded *pro rata* cash recoveries for lenders that decided not to participate in the credit bid and receive equity in the new company owning the debtor's assets.
  - This structure allows non-participating lenders to opt out and receive a cash payment where they would otherwise be subject to the "drag-along" procedure effected in *GWLS* and *Metaldyne* (and attempted in *Electroglas*).
  - While this structure required participating lenders to put up more cash than in a pure credit bid, such lenders receive, as a result, more equity than that to which they would otherwise be entitled on account of their loan holdings.
  - Worth noting, however, is the fact that the feasibility of credit bids can be significantly diminished if non-credit bidding lenders are required to be paid cash by the credit bidding lender or lenders to ensure equal treatment from the net pay-down perspective of the entire group.

Credit Bidding—Lender Bidding Group Issues (cont'd)

Treatment of Lenders Opposing Credit Bid

- To the extent unresolved, however, the claims of non-credit bidding lenders against the agent and the credit bidding lenders relating to the credit bid and enforcement of the equal treatment provisions are typically not determined by the Bankruptcy Court because they do not involve the debtor or the bankruptcy estate. Such claims are usually reserved for potential litigation in state or other federal courts.

Credit Bidding—Lender Bidding Group Issues (cont'd)

Acquisition Vehicle Corporate Governance

- In most cases, the agent and members of a syndicated lending group establish a special purpose entity ("SPE") to serve as an acquisition vehicle for their credit bid.
  - The lenders' liens and claims are contributed to this vehicle and all issues relating to participation in the credit bid, ownership interests in the acquired assets, corporate governance, and distributions of assets/recoveries are addressed in the relevant SPE documentation.
- The mechanics required to formulate a credit bid vary based on the particulars of the credit agreement.
  - Often, the consent by lenders holding at least 50 percent of the dollar amount of a bank loan group's secured credit is required to direct the agent to execute a credit bid, but these requirements may vary from agreement to agreement.
  - The same governance dynamic is likely to apply to approve increases or changes in the credit bid amount.
    - Intercreditor dynamics of formulating a credit bid can be contentious and time consuming, but these disputes often are aired only privately among members of the lender group.
- The mechanical issues of credit bidding may be complicated further by the presence of second-lien debt, which may have a different (*i.e.*, higher) view of value than do first-lien creditors.
  - In these cases, the intercreditor agreement usually defines credit bidding and other rights of second-lien holders as related to the first-lien holders.
  - The interpretation and enforcement of intercreditor agreements in this context gives rise to an entirely separate set of interpretational issues that crosses over with Intercreditor agreement issues raised in other contexts.

Credit Bidding—Lender Bidding Group Issues (cont'd)

Credit Bidding Group Disputes: Allied (Yucaipa v. Black Diamond)

- A noteworthy case where the competing interests of the various lenders could not be resolved in the acquisition vehicle documentation was *In re Allied Systems Holdings*, Inc., Case No. 12-11654 (CSS) (Bankr. D. Del. 2013).
  - In that case, Yucaipa, which was both a controlling shareholder and lender to Allied Systems Holdings, Inc. ("Allied"), had squared off against Black Diamond and Spectrum, who were minority lenders.
  - Black Diamond and Spectrum contended that in prior amendments to the relevant credit agreement all the lenders had agreed to modify the agreement to prevent Yucaipa, as Allied's controlling shareholder, from gaining control of the first-lien debt as well.
  - Yucaipa countered that the first-lien loan documents had been properly amended to permit it to purchase a controlling position of the first-lien debt
  - The dispute ultimately led to the filing of an involuntary bankruptcy petition against Allied by Black Diamond and Spectrum in May 2012.
- The conflict continued to unfold in both the Delaware bankruptcy court and New York state court—including in the context of the sale process proposed by Allied, and was not resolved until Judge Sontchi ruled that Black Diamond and Spectrum would serve as the "requisite lenders" for purposes of the Allied section 363 auction.
  - A $105 million bid (consisting of $40.5 million in cash and a credit bid of $64.5) from Black Diamond and Spectrum, now recognized as the "requisite lenders" in control of the first lien debt, was declared the winning bid.
  - The truce was short-lived, however, with litigation recommencing when the creditors' committee objected and moved for a new auction, arguing that the auction failed to comply with the bidding procedures and that a competing all cash $100 million bid from a strategic bidder was actually a "higher and better" offer for Allied's assets.

Credit Bidding—Lender Bidding Group Issues (cont'd)

- A new auction was thereafter held at which the strategic bidder's new bid, consisting of $125 million in cash and $10 million in notes, was determined to be the winning bid, leaving both Yucaipa and Black Diamond/Spectrum empty-handed.

Credit Bidding—Lender Bidding Group Issues (cont'd)

Bidding Group Disputes: GSC (Black Diamond v. Non-Controlling Lenders)

- In another high-profile dispute, Black Diamond Capital Management LLC ("Black Diamond") and the chapter 11 trustee to the investment management firm GSC Group Inc. ("GSC") dueled with GSC's minority lenders (the "Non-Controlling Lenders") over the proposed $235 million sale of GSC's assets to Black Diamond.
  - GSC lined up the deal with Black Diamond—which beat out the minority lenders for the purchase—following a 363 sale auction, a path the investment firm chose to pursue instead of a Chapter 11 reorganization.
  - Under the terms of the $235 million purchase, the Non-Controlling Lenders were set to receive no more than $38 million for claims totaling more than $250 million, whereas Black Diamond would wind up with ownership of the assets and control of the company.
  - The Non-Controlling Lenders argued that there was no compelling reason to rush the sale, which they said should instead be used as a backup option in case a reorganization plan could not be confirmed.
    - The chapter 11 trustee took issue with the minority lenders' assertion that GSC's businesses had stabilized, and could therefore sustain a lengthy confirmation process.
- The Non-Controlling Lenders argued, among other things, that Black Diamond's vote should be designated.
  - The Non-Controlling Lenders did so based upon the overarching allegation that "the Proposed Sale Transaction allow[ed] [Black Diamond] to obtain more than its ratable share of the Debtors' assets." (NCL Prelim. Obj. to Sale Motion, ECF No. 220, p. 4.)
  - More specifically, the Lenders contended that Black Diamond would "receive through its $11 million share of the BD Joint Bid assets of the Debtors worth at least $111 million, which [was] substantially more than 100% of its outstanding claims against the Debtors, while other Lenders [would] receive, through their share of the Credit Bid Assets, less than 17% of their outstanding claims."

Credit Bidding—Lender Bidding Group Issues (cont'd)

Bidding Group Disputes: GSC (Black Diamond v. Non-Controlling Lenders)

- In the end, the Non-Controlling Lenders' designation request was denied and Black Diamond prevailed.
  - While the record contained a number of allegations against Black Diamond regarding its desire to consummate a sale in which it could have "unfairly taken advantage of its control over the allocation," the Non-Controlling Lenders were unable to prove up their "fact intensive" allegations in a manner satisfactory to the court. (NCL Obj. to Sale Motion, ¶¶ 56, 108-10.)
  - Their motion to designate was denied and the sale to Black Diamond approved over the objections of the Non-Controlling Lenders that the sale should be delayed to allow for a proper Chapter 11 proceeding and the consideration of a reorganization plan that would protect the lenders from losses they would suffer if the sale to Black Diamond were consummated.

Credit Bidding: Collateral Coverage and Gaps

Credit Bidding—Collateral Coverage and Gaps

Credit Bids Limited to Lender Collateral

- Credit bids generally can be applied only to the lender's collateral, which raises issues regarding a lender's ability to credit bid for a basket of assets that includes other elements of value in addition to its collateral.
  - Such elements could include non-debtor subsidiaries, such as foreign operations, or assets that cannot be attached by liens, such as gaming or other governmental licenses.
  - In these circumstances, there may be an allocation of value among the collateral and non-collateralized assets, and separate consideration may be provided to the estate for these purchases.
- In addition, allocating total enterprise value to specific assets (*i.e.*, encumbered versus unencumbered) on a piecemeal basis can be challenging.
  - For example, in the bidding war for the assets of Hollywood Casino Shreveport, a dispute arose regarding how much of the purchase price should be ascribed to non-collateral assets, such as the gaming license.
  - By statute, the license could not be subject to a lien, and its value therefore was available for distribution to the debtor's unsecured creditors.
- Credit bids in the context of sales of all or substantially all assets of a debtor may also create interesting competitive dynamics.
  - A credit bid provides a threshold value for the company and can provide valuable assurance to creditors and other parties that a business will continue to operate.
  - At the same time, credit bidding can complicate the dynamics of the auction process. For example, a group of secured lenders may provide a debtor with a credit bid for less than the full amount of their claim, which then would serve as a floor below which no third-party cash bids would be accepted.

Credit Bidding—Collateral Coverage and Gaps (cont'd)

Credit Bids and Blanket Liens

- Such dynamics aside, the credit bid context raises difficult issues—as to what is being acquired and for what value—when a lender group with an "all assets" or "blanket" lien, bids for "all or substantially all" of a debtor's assets.
  - When a lender seeks to obtain, and the debtor agrees to grant, a first-priority "blanket" lien on all of the debtor's assets, the intentions of the parties are clear, but notwithstanding such intentions, blanket liens may have gaps.
  - A security interest in collateral automatically extends to the identifiable proceeds of that collateral, but not all property can be properly encumbered by a security interest as a legal or practical matter.
  - The scope of UCC Article 9 is broad, but a security interest granted thereunder may or may not encompass such things as franchise licenses, government-issued licenses (*e.g.*, FCC and gaming licenses) or certain causes of action (*e.g.*, commercial torts).
  - Diligent lenders will seek to perfect their liens as to all liened assets, but certain classes of collateral, such as real property interests and intellectual property, may raise perfection challenges.
  - With a view to cost issues, lenders may also elect not to pursue perfection with respect to collateral (*e.g.*, rolling stock and leasehold interest) where the cost of perfection may outweigh the collateral's liquidation value.
- Confronted with gaps in collateral packages, courts have nonetheless found ways, in both the sale and plan contexts, as illustrated by the following cases, to validate secured lenders' claims to enterprise value based upon evidence of the parties' intention to grant "blanket" liens.
  - *In re Kim*, 130 F.3d 863 (9th Cir. 1997). In *Kim*, the Ninth Circuit granted a secured lender the benefit of the debtor's enterprise value, where the lender's collateral included a leasehold interest in the debtor's store and the equipment on its premises, but not a related franchise agreement. The chapter 13 debtor argued that the assets

Credit Bidding—Collateral Coverage and Gaps (cont'd)

should be valued on an item-by-item basis and that no value should be assigned to the lease because it was above-market. The secured creditor argued that the debtor had undervalued the collateral by valuing the equipment and the lease separately, rather than as a "turn-key" package. The Ninth Circuit agreed with the secured creditor, concluding that "holding both the lease and equipment gave appellants a package that was worth more than if the two were valued separately. Selling the equipment alone (as an off-location valuation implies), and then selling the lease, as vacant premises with no improvements and no equipment, is impractical and would not maximize the value of the collateral." *Id.* at 865.

- *In re Chateaugay Corp.*, 154 B.R. 29 (Bankr. S.D.N.Y. 1993) (Lifland, J.). In *Chateaugay*, the bankruptcy court held that a secured creditor's liens attached to the going concern value of a debtor even where the grant of those liens included only hard assets. The *Chateaugay* debtor asserted that the court should not consider going-concern value in valuing the secured creditor's interest in the relevant collateral (*i.e.*, a steel mill) because the debtor had not granted the creditor an interest in the intangible assets that constitute going-concern value. Looking to section 506(a) of the Bankruptcy Code, the *Chateaugay* court declined to focus its analysis on the "granting clause" of the relevant instrument, which, because it did not include intangibles, might have denied the secured creditor a lien on going-concern value. Instead, the court proceeded on the assumption that "the value of the creditor's interest '*shall* be determined in light of the purpose of the valuation and of the proposed disposition or use'" of the collateral. (*Id.* at 33 (quoting section 506(a)). Given the debtors' announced intention to operate the relevant assets after its chapter 11 reorganization, the court concluded that a going-concern valuation was required.
- *In re Oklahoma City Broadcasting Co.*, 112 B.R. 425 (Bankr. W.D. Okla. 1990). In *Oklahoma City Broadcasting*, the debtor operated a television station in a market that was not large enough to support it and two other independent stations. A creditor held a security interest in virtually all of the debtor's assets, including general intangibles, but did not have a lien on the debtor's FCC license. At plan confirmation, the debtor contended that the creditor's secured claim should be limited to the value the debtor's hard assets would bring at a foreclosure sale. The secured creditor argued that it was entitled to the going-concern value of the debtor. The unsecured creditors' committee contended that

Credit Bidding—Collateral Coverage and Gaps (cont'd)

the value of the secured creditor's claim should be the debtor's going-concern value minus the value of its FCC license. The court rejected the debtor's approach because it ignored the fact that the secured creditor had a lien on more than just the debtor's hard assets. The court also rejected the secured creditor's proposed valuation, because it ascribed the entire going-concern value to the secured creditor, noting that a television station without an FCC license would not be a going concern. Finally, the court rejected the committee's approach because "the going concern value is not a relevant value at this stage of the proceedings," noting that the secured creditor had moved for relief from stay and "if that relief is granted, there will be no 'going concern' to be valued." *Id.* at 425 n.5. Ultimately, the court concluded that the proper method for determining the amount of the creditor's secured claim would be to determine the market value of the creditor's specific collateral.

- *In re Hawaiian Telecom Commc'ns., Inc.*, 430 B.R. 564 (Bankr. D. Haw. 2009). In *Hawaiian Telecom*, the secured lenders, who were significantly undersecured, had a lien on the principal assets necessary to operate the debtors' telecommunications business, including all equipment, investment property, all real property above a certain value, all general intangibles (including brand names, intellectual property, customer lists and relationships, and goodwill), and all proceeds of the foregoing. The lenders' lien, however, did not attach to the debtors' motor vehicles and certain real property interests, including the 19,000 easements that permitted the debtors to run their telecommunications lines over or under various real property. Nevertheless, the *Hawaiian Telecom* court confirmed a chapter 11 plan that allocated to the secured lenders the "total distributable value" of the debtors' business, less the value of the unencumbered assets, which was to be distributed to unsecured creditors. The court found that the secured creditors were entitled to the debtors' enterprise value where their collateral consisted of the debtors' primary assets and was to be used by the reorganized debtors to operate their business post-emergence.

Credit Bidding—Collateral Coverage and Gaps (cont'd)

Credit Bids and Surplus Value

- Finally, arguments have been—and will continue to be—made by academics and other commentators that secured lenders should not be entitled to anything more than the aggregate value of the identifiable assets (tangible and intangible) to which their liens have attached.
  - The enterprise value premium arising out of a section 363 sale or a sale under a chapter 11 plan pursuant to section 1123 is best viewed, such commentators contend, as Bankruptcy Code-created. *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11*, 123 Yale L. J. 862 (2014).
  - If left to its state-law liquidation remedies, a secured creditor would not receive such a premium. Thus, it may be argued that any value above and beyond the distributional baseline realizable by virtue of state law remedies cannot be said to "belong" to the secured creditor and should instead be allocated in accordance with Bankruptcy Code priorities and policies.
    - Outside of bankruptcy, secured creditors can repossess and foreclose on the assets securing their debt. However, foreclosures outside of bankruptcy are subject to time delays and uncertainty about the title acquired, and effectuating a nonconsensual, going-concern sale may prove impossible.
  - Chapter 11 offers a number of tools designed to enhance the value of the debtor's assets beyond what such assets would be worth if liquidated on the petition date. These tools can preserve value through a reorganization or sale under a chapter 11 plan.
    - In some cases, going-concern value can be enhanced because chapter 11 provides a breathing spell and a chance to fix operational issues.
    - In other cases, the ability to effectuate a quick sale under section 363 of the Bankruptcy Code, free and clear of any and all encumbrances, may increase enterprise value.

Credit Bidding—Collateral Coverage and Gaps (cont'd)

- It can be argued, therefore, that it is chapter 11 itself, and not anything inherent in the collateral or the efforts of the debtor or the secured creditor, that gives rise to some, if not all, surplus or enterprise value of the debtor.
  - Thus, to the extent a debtor is worth more as a going concern than it would be in a piecemeal liquidation—because of its talented workforce, unique contractual and non-contractual relationships, or any other factors—it is not clear that this extra value is tethered to, or subsumed in, the secured creditor's collateral.
- Thus, according to the proponents of this line of reasoning, the secured creditor's right to this Bankruptcy Code-created value is limited to market increase in the value of its identifiable collateral and any traceable proceeds.
- On this basis, even a secured creditor with a purported blanket lien is not likely to have a perfected security interest in all of the debtor's enterprise value.

Credit Bidding: Valuation and Consideration

Credit Bidding—Valuation and Consideration

Face Amount of Debt

- Prevailing case law indicates that a credit bidder may bid up to the face amount of its secured claim—regardless of the actual value of the collateral securing the debt. This was a topic of some debate until the Third Circuit Court of Appeals ruled in the *SubMicron* case that "it is well settled among district and bankruptcy courts that creditors can bid the full face value of their secured claims under [Section] 363(k). In fact, logic demands that [Section] 363(k) be interpreted in this way; interpreting it to cap credit bids at the economic value of the underlying collateral is theoretically nonsensical." *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corporation),* 432 F.3d 448, 459-60 (3d Cir. 2006).
- The Supreme Court arrived at the same conclusion in *RadLAX Gateway Hotels, LLC et al., v. Amalgamated Bank (In re River Road Hotel Partners, LLC),* 132 S. Ct. 845 (2011), when it held that secured creditors may credit bid up to the face amount of their secured claim, and not just the value of their collateral at the time of the sale. *Id.* at *4 n.2 (under section 363(k) "the ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price" and "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. *Id.* (emphasis added).
- It therefore is clear that credit bidders need only produce documentation evidencing the face amount of their secured debt without regard to the underlying value, if any, of the collateral. Together, these holdings have constrained the use of a common litigation tactic, which permitted debtors and committees to argue that section 363(k) of the Bankruptcy Code capped credit bids at the economic value of the underlying collateral, and did not permit credit bidding up to the face amount of the secured creditor's claim.

Credit Bidding—Valuation and Consideration

Subject to Committee Investigation

- A secured creditor may, all other considerations aside, bid up to the face amount of its secured claim. However, the bid ultimately available to a particular secured creditor will turn on the creditors' committee investigation as to the validity, perfection, and proper amount of that lender's claims.
- The DIP order generally grants, as set forth above, the creditors' committee a period of time (typically 60 to 90 days) and a limited budget to investigate the liens and claims of the debtor's prepetition lenders.
- To the extent that the committee investigation results in the limitation on the lender's liens or the reduction of its claims, these changes will likely have an impact on how much the lender is able or willing to credit bid.
  - If, for example, the lender's liens are limited, it would be entitled to credit as to less of the debtor's collateral and, thus, potentially inclined to bid in less of its debt.
  - If, in turn, its claim were reduced (*e.g.*, by elimination of interest accrual, expense entitlements, premiums, etc.), it would have less credit bid currency to deploy and thus bid less.

Credit Bidding—Valuation and Consideration

Non-Credit Bid Currency and Consideration

- When a secured lender seeks to credit bid for a basket of assets that includes elements of value in addition to its collateral (*e.g.*, non-debtor subsidiaries, such as foreign operations, or assets that cannot be attached by liens, such as gaming or other governmental licenses), it will generally be required to enhance its bid with cash or other consideration.
- Such consideration can take a number of forms and be contributed through a variety of mechanics.
  - For example, it might come in as a cash deposit that a secured lender might not otherwise be required to post if its bid were limited to its collateral and be credited to a combined credit bid/cash bid if the secured lender prevailed.
    - However, acknowledging the round-trip nature of such a cash contribution, secured lenders are more frequently absolved from any obligation to post a deposit by the bidding procedures order. *See, e.g.*, *In re Relativity Fashion, LLC*, Case No. 15-11989 (MEW) (Bankr. S.D.N.Y. (Sept. 1, 2015) (carving secured lender credit bids out from all "qualified bid" requirements including tender of "good faith deposit").
  - Alternatively, it might be added expressly to the credit bid, especially if the secured creditor seeks to obtain assets beyond the scope of its collateral, either at the stalking-horse or later auction stage.
    - *See, e.g.*, *In re The Bon-Ton Stores, Inc.*, No. 18-10248 (Bankr. D. Del. Feb. 6, 2018).

Credit Bidding—Valuation and Consideration

Non-Credit Bid Currency and Consideration

- As a further alternative, the secured lender could be credited for other contributions it committed to make, such as with respect to (i) wind down expenses; (ii) assumption of liabilities; or (ii) forgiveness of postpetition financing.
  - *See, e.g.*, *In re Vertellus Specialties Inc.*, Case No. 16-11290 (CSS) (approving credit bid sale on, among others, the ground that the "aggregate amount of such cash consideration for the Debtors and the unsecured creditors" contributed by the secured lender "include[d] section 503(b)(9) payments, cure costs, accrued administrative expenses, and assumed trade and other liabilities . . . exceed[ed] $49 million.")
- Comparable credits are afforded to cash bidders, in the overall apple-to-apple calculus, so there is no reason that a credit bidding secured lender should not be entitled to put to use similar currency and consideration.

Credit Bidding—Value and Consideration—*Aerogroup*

Credit Bids and Value of Collateral/Secured Claim

- In *In re Aerogroup International, Inc.,* Case No. 17-11962 (Bankr. D. Del. June 20, 2018), the question was whether a secured lender's unsuccessful credit bid ($12.2 million), or the winning credit bid by a competing bidder ($25.4 million), set the value of the asset and, in turn, the value of the losing lender's secured interest.
  - In *Aerogroup*, a secured creditor (owed $19.7 million) held a security interest in an asset being sold by the debtor in a 363(b) sale. The creditor, pursuant to its 363(k) right to credit bid for that asset, bid $12.2 million for the asset at the auction, was outbid, and subsequently refrained from credit bidding any further. The asset was sold to a competing bidder for $25.4 million.
  - The issue arose in the context of a summary judgment motion in an adversary proceeding where a competing second-lien lender sought to set the value of the first-lien lender's secured claim for purposes of allocating and distributing the proceeds of the asset sale.
  - The competing second-lien lender argued that the first-lien lender's "final" credit bid of $12.2 million established the secured amount of the losing bidder's claim. The relevant secured creditor (bidder of $12.2 million) argued that an unsuccessful credit bid does not set the value of a lender's secured interest. Rather, a *winning* credit bid represents the market value of the asset.
  - The court ultimately found that (i)"[*t*]*he highest bid* – no matter who makes it – sets the asset's value" because "[a]n auction allows the marketplace to determine the value of the collateral, which, in turn, determines the value of the secured portion of the claim."
- In so doing Judge Carey affirmed the conclusion that the value of an asset is established by what the market will pay for it.

Credit Bidding—Value of Collateral—*Aerogroup*

- In support of its argument, the competing *Aerogroup* second-lien lender had pointed to a line of Third Circuit cases that, it argued, supported the proposition that the first-lien lender's "final" credit bid established the secured amount of its claim at $12.2 million, but Judge Carey rejected the lenders reliance on *In re Submicron Systems*, 432 F.3d 448 (3d Cir. 2006) and *In re Philadelphia Newspapers, LLC*, 599 F. 3d 298, 301 (3d Cir. 2010) as predicated on "language plucked . . . without context" from these decisions by the second-lien lender and, thus, not supporting an argument dispositive of the issue.

- Based on the foregoing analysis, Judge Carey held that "the highest bid – no matter who makes it – sets the asset's value," and rejected the second-lien lender's claim that any credit bid by a secured lender, by definition, sets the upper limit of its secured claim.
  - In Judge Carey's words, "an auction allows the marketplace to determine the value of the collateral, which, in turn, determines the value of the secured portion of the claim."
    - A standalone credit bid, which is not the winning bid, can have no comparable impact on setting the value of a secured claim.
- Among other things, as one commentator observed, the opinion "helps to preserve credit bidding as a tool for achieving higher and better offers and avoids creating a situation where secured creditors may be forced either to overbid for an asset or to abstain from credit bidding altogether."

Adequate Protection: *Rescap, Chardon*, and Illusory Adequate Protection

Adequate Protection—General Principles

- The fundamental issue in most adequate protection disputes is the "adequacy" of the "adequate protection" afforded to a secured lender.
- The answer to this question turns on, among other factors, the value of the secured creditor's collateral, and the movement up or down of this value over the course of the debtor's chapter 11 case from petition date through confirmation.
  - To the extent adequate protection becomes inadequate, a creditor can seek to have its claim for such inadequacy treated as a super-priority administrative expense claim under section 507(b) of the Bankruptcy Code.
- The objective is to strike a balance between sufficient/proportional and insufficient/disproportional adequate protection (*i.e.*, in the range between "just enough" and "more than enough").
  - The purpose of adequate protection is to ensure that prepetition secured lenders receive the security they bargained for prior to the petition date. *See In re Sonora Desert Dairy*, 2015 WL 65301, at *11 (B.A.P. 9th Cir. Jan. 15, 2015) ("In other words, adequate protection is provided to ensure that the prepetition creditor receives the value for which the creditor bargained pre-bankruptcy"); *In re Park W. Hotel Corp.*, 64 B.R. 1013, 1017 (Bankr. D. Mass. 1986) ("Derived from the fifth amendment protection of property interest, adequate protection . . . constitutes a legislative attempt to reconcile the competing interests of debtors, who need freedom from harassing creditors in order to effectuate reorganizations, and secured creditors, who are entitled to some measure of protection for their bargained for property interest" (internal citations omitted)).
  - In thus protecting secured creditors' expectations, however, adequate protection must be narrowly tailored to the circumstances of the specific bankruptcy case to obviate secured creditors obtaining greater rights than those for which they bargained. *See In re Am. Mariner Indus., Inc.*, 27 B.R. 1004, 1006-07 (B.A.P. 9th Cir. 1983) ("[U]ltimate meaning of the term [adequate protection] will be developed in a case-by-case basis, in each instance with the relief being tailored to the fact situation") (quoting 2 *Collier on Bankruptcy* (15th Ed.) § 361.01[1] (1983)); *In re Pelham Street Assocs.*, 131 B.R. 260, 263 (Bankr. D. R.I. 1991) ("'[A]dequate

Adequate Protection—General Principles (cont'd)

protection' under the Code is a flexible concept, to be tailored to the particular facts and circumstances of each case"); *In re Briggs Transp. Co.*, 35 B.R. 210, 217 (Bankr. D. Minn. 1983) ("A flexible definition of adequate protection is essential to insuring that the balance [Congress has struck between its policy in favor of the rehabilitation of debtors and the property rights of creditors] is tailored to the facts and circumstances of each case.")

- The ultimate objective of providing adequate protection to prepetition secured parties is to preserve the *status quo*, not to better those parties' positions. *See, e.g.*, *In re 354 E. 66th St. Realty Corp.*, 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995) ("The purpose or intent of granting adequate protection payments [is] to maintain the *status quo* for that creditor and to protect the creditor from diminution or loss of the value of its collateral during the ongoing Chapter 11 case. If that creditor is oversecured or if there is no reason to believe that the collateral will diminish, then adequate protection payments may not be granted"); *In re Roe Excavating, Inc.*, 52 B.R. 439, 440 (Bankr. S.D. Ohio 1984) ("Adequate protection generally is meant to preserve the secured creditor's position at the time of bankruptcy.")

- Striking the appropriate balance is particularly difficult when the issue is providing adequate protection with respect to the use of "cash collateral," as is illustrated in discussions of the *ResCap* and *Chardon* cases that follow.

Adequate Protection (*ResCap*)

- The adequacy of stipulated adequate protection was central to a dispute between Residential Capital LLC and its affiliated debtors (collectively, "ResCap") on the one hand, and the indenture trustee, the collateral agent, and an *ad hoc* group of the debtors' junior secured noteholders (collectively, the "JSNs"), on the other hand, in *In re Residential Capital LLC*, 497 B.R. 403, 419-20 (Bankr. S.D.N.Y. Sept. 20, 2013).
- At the outset of the *ResCap* case, the debtors and the JSNs reached an understanding regarding the consensual use of cash collateral, and the court entered an order (the "Cash Collateral Order") mandating, *inter alia*, that the debtors were authorized to use the JSNs' cash collateral in accordance with an approved budget.
  - In return, the JSNs received an adequate protection package consisting of (1) adequate protection liens on their existing collateral as well as on certain additional assets, (2) adequate protection payments in the form of professionals' fees for the indenture trustee and the *ad hoc* group, and (3) super-priority claims under section 507(b) of the Bankruptcy Code.
  - Notably, but unsurprisingly, the Cash Collateral Order did not specify an initial value for the JSNs' collateral, nor did it mandate a methodology by which the parties should value the collateral or calculate any diminution in its value.
- In the course of the chapter 11 case, the JSNs claimed that they were oversecured creditors and asserted secured claims in the amount of $2.22 billion, plus postpetition interest and fees—claims that were vigorously disputed by the *ResCap* debtors and creditors' committee.
  - Among other arguments, the JSNs claimed that they were oversecured and thus entitled to an adequate protection claim due to the debtors' use of their cash and non-cash collateral during the case.

Adequate Protection (*ResCap*)(cont'd)

  - Specifically, the JSNs argued that they were entitled to an adequate protection claim in an amount equal to each dollar of the JSNs' cash collateral used by the debtors during the bankruptcy case, notwithstanding that the debtors were using such cash pursuant to the Cash Collateral Order.
  - On the basis of this argument, the JSNs sought a declaration that the debtors' use of cash collateral results in a *per se* diminution of the collateral's value, and that the debtors' waiver in the Cash Collateral Order of their rights under Section 506(c) of the Bankruptcy Code to surcharge the JSNs' collateral prevented the debtors from allocating expenses to the JSNs under the budget without compensating the JSNs for such use through an adequate protection claim.
- The court rejected the JSNs' "dollar-for-dollar" theory, holding that "not every use of cash collateral constitutes a *per se* diminution in the value of the JSNs' collateral." Indeed, "since the court has found that the JSNs are adequately protected so long as the debtors only use cash collateral pursuant to the cash collateral order, 'by definition, there is no surcharge and Section 506(c) does not come into play.'"
  - In a later decision, the court further noted that "[u]nless the remaining value of the cash and noncash collateral at the effective date falls below the value of the collateral on the petition date, the creditor is not entitled to compensation for the amount of cash collateral spent under the approved budget."
  - Thus, as the *ResCap* court made clear elsewhere, the issue at trial would be whether the JSNs suffered a diminution in the value of their collateral—that is, that the "dollars" spent by the *ResCap* debtors did not play a role and/or succeed in preserving the value of the JSNs' collateral—between the petition date and the effective date of the debtors' chapter 11 plan.
  - Following extensive briefing and a multi-day trial, the court found that the JSNs were not entitled to any adequate protection claim, due, in part, to the fact that the "dollars" spent in accordance with the Cash Collateral Order did, in fact, play a part in preserving (and even enhancing) the value of the JSNs' collateral.

Adequate Protection (*ResCap*)(cont'd)

- While the "dollar-for-dollar" theory did not prevail in *ResCap*, there are situations where each dollar of cash collateral spent could result in a *per se* diminution in value (*e.g.*, where the cash collateral spent has little to do with the preservation or sale of the collateral).
- In such cases—as is apparent in the discussion of *Chardon* that follows—the secured creditors would be well-advised to either (i) seek reimbursement of such amounts in the form of ongoing adequate protection payments; or (ii) factor diminution on this basis into the methodology for calculating an end-of-the-case section 507(b) (or "failure of adequate protection") claim.

Adequate Protection (*Chardon*)

- In *In re Chardon, LLC*, Case No. 13-81372, ECF No. 1143, (Bankr. N.D. Ill. Jan. 13, 2015), the United States Bankruptcy Court for the Northern District of Illinois denied the request by a debtor to use an undersecured creditor's cash collateral, which took the form of postpetition rents, to pay chapter 11 professional fees, holding that the undersecured creditor was not adequately protected even though the value of its collateral had not been shown to have declined and might, instead, be increasing.
  - Donald Wolf, Sr. and his two sons each commenced individual chapter 11 cases and their cases were consolidated with the chapter 11 cases of the entities through which the Wolf family operated its real estate business.
  - The three Wolfs collectively held all beneficial interests in a land trust that owned the Huntley Building, one of several commercial properties owned by the Wolf family. They also jointly and severally owed FirstMerit National Bank ("FirstMerit") approximately $15 million under certain loans and guaranties. The FirstMerit debt was cross-collateralized and secured by various of the Wolfs' real properties, as well as an assignment of rents generated by the Huntley Building.
  - It was conceded that FirstMerit was undersecured. It was also acknowledged that the real property collateral had a market value that was stable and "likely will increase over the long-term."
- The Wolf debtors sought authorization to use rental income generated by the Huntley Building to pay approximately $279,000 in fees incurred by the Wolf debtors' professionals. The Wolf debtors alleged that, at the time of the relevant motion, they held approximately $326,000 in rents from the Huntley Building and that the property then generated approximately $52,000 of rental income per month.
  - The Wolf debtors argued that FirstMerit was adequately protected for the proposed use of cash collateral because (i) the value of the real estate collateral was not diminishing; and (ii) the Wolf debtors would grant FirstMerit replacement liens on future rents. In addition—although they believed it was unnecessary—the Wolf debtors offered to make future and continuing interest payments to FirstMerit on the portion of the debt attributable to the Huntley Building.

Adequate Protection (*Chardon*) (cont'd)

- The bankruptcy court denied the request, holding that FirstMerit was not adequately protected under the circumstances because (i) FirstMerit was undersecured and (ii) the proposed forms of adequate protection were illusory.
  - *First*, the bankruptcy court rejected the prior decision of the same court in *Addison Properties*, in which the court held that a secured creditor's claim should be fixed at the beginning of the case for the purpose of determining adequate protection and, therefore, postpetition proceeds covered by section 552(b) do not increase the amount of a secured creditor's claim entitled to adequate protection.
    - The Wolf debtors relied on *Addison Properties* to argue that FirstMerit would be adequately protected for the use of its cash collateral so long as the Huntley Building was not decreasing in value.
  - *Second*, the bankruptcy court considered decisions from the Northern Illinois District Court and Seventh Circuit and concluded that section 552(b) of the Bankruptcy Code establishes a separate security interest in postpetition rents, which interest is entitled to separate adequate protection.
    - Under the dual valuation approach thus mandated, however, the separate security interest in postpetition rents would be valued at zero and receive no adequate protection because that approach disregards postpetition rents for adequate protection purposes.
    - Thus, the bankruptcy court held that the dual valuation approach was inconsistent with section 552(b). It is worth noting, however, that the bankruptcy court's concerns in this regard may be obviated, if not resolved, where the secured creditor is adequately protected by an equity cushion that is greater than the postpetition rents to be used.
  - *Finally*, the bankruptcy court, reviewing recent decisions from outside the Seventh Circuit, concluded that a majority of courts have held, in a variety of contexts, that a secured creditor's interest in postpetition rents is separate from its interest in the underlying real property.
    - Thus, the bankruptcy court concluded that a "fair reading" of sections 506(a) and 552(b) of the Bankruptcy Code requires that a secured creditor's separate interest in postpetition rents must be considered for adequate protection purposes.

Adequate Protection (*Chardon*) (cont'd)

- When a creditor is undersecured, the use of its cash collateral generally represents a dollar-for-dollar reduction in that creditor's collateral.
  - Nevertheless, undersecured creditors may—and often do—consent to use of their cash collateral to pay estate professional fees when the debtor lacks unencumbered cash with which to fund restructuring expenses.
  - If, however, an undersecured creditor determines that a restructuring is not in its best interests, refusing to fund restructuring expenses from cash collateral may be one of its most powerful weapons.
  - In *Chardon*, the bankruptcy court addressed non-consensual use of an undersecured creditor's cash collateral to pay estate professional fees and determined that such use was impermissible unless the secured creditor received adequate protection from unencumbered collateral—which generally excludes postpetition rent per section 552(b)—or the debtor met the more rigorous standard to surcharge collateral.
- Undersecured creditors already face an array of vexing issues when confronted with a cash-strapped chapter 11 debtor, but the decision in *Chardon* offers an additional avenue for the protection of their collateral from further diminution.

Other Developments: Section 1111(b) Elections and Lien Stripping

Section 1111(b) Elections and Credit Bidding (*Baker Hughes*)

- Among the Bankruptcy Code provisions intended to protect the rights of undersecured creditors are the following:
  - Section 363(k), which permits a secured creditor with a lien on property being sold pursuant to section 363 to credit bid its claim in any such sale unless the court, for cause, orders otherwise;
  - Section 1111(b)(1), which permits an undersecured creditor to assert its deficiency claim, together with other unsecured creditors, even though the secured debt was issued on a nonrecourse basis; and
  - Section 1111(b)(2), which permits an undersecured creditor to elect to retain its lien for the full amount of its claim, avoiding the bifurcation of its claim between secured and unsecured, and forgoing any recourse that it may have as an unsecured creditor.
- The Fifth Circuit addressed these three provisions and their interdependent roles in protecting the rights of secured creditors in *Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.)*, 784 F.3d 978 (5th Circ. 2015).
  - In *Baker Hughes*, the debtor sold substantially all of its assets pursuant to section 363 of the Bankruptcy Code as an element of the debtor's confirmed chapter 11 plan. Prior to confirmation of the plan, one of the debtor's undersecured creditors, Baker Hughes Oilfield Operations, Inc. ("Baker Hughes"), which held a lien on some of the assets subject to the sale, made an election pursuant to section 1111(b)(2) to have its claim treated as secured to the full extent of its claim.
  - The proposed asset purchaser objected, contending that, pursuant to section 1111(b)(1)(B)(ii), such an election is unavailable where the debtor undertakes to sell the encumbered property pursuant to section 363. The debtor's plan was confirmed without objection by Baker Hughes.
  - Subsequent to confirmation, Baker Hughes again argued that, as a secured creditor, it had the right to either credit bid at the sale of the collateral or be granted its election under section 1111(b)(2). The bankruptcy court and the district court both denied Baker Hughes's claim, and the Fifth Circuit affirmed.

Section 1111(b) Elections and Credit Bidding (*Baker Hughes*)

- The majority's opinion acknowledged the importance of a secured creditor's credit bid right, but found that the debtor's plan had, at least implicitly, afforded the secured creditor the requisite credit bid right by proposing a sale "pursuant to § 363," and that Baker Hughes waived its right to credit bid by neither seeking to make a credit bid nor objecting to confirmation of the plan.
- The majority rejected Baker Hughes's argument that a trustee or a debtor in possession has the responsibility to make arrangements, or otherwise facilitate a credit bid, for a secured creditor who fails to act on its rights.

- Ultimately, the majority held that the sale was valid under section 363 and, accordingly, the secured creditors were not entitled to exercise an election under section 1111(b)(2).
- Judge Jones concurred with the majority's decision; however, she took issue with the majority's reasoning.
  - In concurring with the majority's decision, Judge Jones observed that Baker Hughes's actual position in the debtor's capital stack undermined its claims regarding lien structure denial of a credit bid right: Baker Hughes, as a materialmen's lienholder, could in theory make a credit bid, but practically would never do so because of the need to pay off senior liens as part of the bid. It was on this basis alone that Judge Jones concurred with the majority's decision.
  - Judge Jones challenged the majority's reasoning, noting that if extended beyond the facts of *Baker Hughes*, the majority's approach would effectively condone a sale of substantially all of the debtor's assets outside of a public auction without any effort to protect the secured creditors' right to credit bid and without the protection of the section 1111(b)(2) election.
  - Judge Jones held that the prohibition against the section 1111(b)(2) election in the context of a section 363 sale should only apply where the secured creditors are, in fact, assured the right to credit bid their collateral. Notably, Judge Jones stated that such assurance is not met by simply "attaching the statutory labels to a debtor's proposed collateral sale."

Lien Stripping (*Caulkett*)

- In *Bank of America, N.A. v. Caulkett*, 575 U.S. ___, 135 S. Ct. 1995 (2015), the Supreme Court reversed an Eleventh Circuit decision permitting individual chapter 7 debtors to "strip" junior liens on their homes when the first-priority liens were underwater.
  - Relying on *Dewsnup v. Timm*, 502 U.S. 410 (1992), the Supreme Court unanimously held that section 506(d) of the Bankruptcy Code does not allow the debtor to "strip" a junior creditor's lien, where the junior creditor's claim is an *allowed* secured claim.
- The debtors in question each had two mortgage liens on their respective residences. Bank of America held the junior mortgage lien on each residence.
  - The amount owed to the senior mortgagor was greater than the current market value of each home, leaving Bank of America's junior liens entirely underwater.
  - In their respective bankruptcies, the debtors sought to avoid the junior mortgage liens under section 506(d), which provides that where a lien secures a claim that is not an *allowed* secured claim, the lien at issue is void.
  - The respective bankruptcy courts granted the motions, and, in each case, the district court and the Eleventh Circuit affirmed the bankruptcy court's decision. Bank of America appealed to the Supreme Court.
- The Supreme Court first acknowledged that on a plain meaning reading of the Bankruptcy Code, the debtors would have been able to avoid the liens of Bank of America.
  - Specifically, section 506(a)(1) provides that an allowed claim is a secured claim to the extent of the value of the creditor's interest in the property securing the claim, and is an unsecured claim to the extent that the value of the creditor's interest in the property is less than the amount of the allowed claim.

Lien Stripping (*Caulkett*) (cont'd)

- Stated differently, if the value of a creditor's interest in the property is zero, the claim would be an unsecured claim within the definition of section 506(a)(1). Section 506(d) also uses the phrase "allowed secured claim" so it would be logical for the phrase to have the same meaning in both subsections.

- The Supreme Court, however, had already adopted a different interpretation of the phrase "secured claim" for the purposes of section 506(d) in *Dewsnup*, where the Supreme Court rejected the chapter 7 trustee's attempt to strip a partially underwater lien down to the value of the collateral.
  - In *Dewsnup*, the Supreme Court defined the term "secured claim" in section 506(d) to mean a claim that was "supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim." Accordingly, the Supreme Court held here that because (i) the claims in question were secured by liens and (ii) *allowed* under section 502, they could *not* be voided under section 506(d) even when completely underwater.

- The Court noted repeatedly that the debtors did not ask for *Dewsnup* to be overruled, but rather only requested that the Court limit *Dewsnup*'s application to situations where the liens in question were only partially underwater.
  - The Court declined to adopt this proposed distinction between wholly and partially underwater liens on the grounds that applying this approach would leave an "odd statutory framework" in place, under which, if a court valued the collateral at a dollar more than the amount of the senior mortgage, the debtor could not strip down the lien, whereas if the court valued the collateral at one dollar less than the amount of the senior mortgage, the debtor could strip off the entire junior lien.

Lien Stripping (*Caulkett*) (cont'd)

- It is generally understood that courts can avoid the liens of secured creditors in chapter 11 cases. However, some courts have disallowed lien-stripping in chapter 11 cases, or otherwise ruled that liens should "ride through" the bankruptcy.
- The majority of courts permitting lien-stripping in the chapter 11 context do not rely on section 506(d), however, but rather point to different statutory hooks – such as the cram-down provisions for chapter 11 plans, the right of a class of creditors to make an election under section 1111(b), and section 1123(b)(5), which permits modification of the rights of holders of secured claims (except for those claims secured solely by a debtor's principal residence).
- Another group of decisions interpret the Bankruptcy Code to prevent lien-stripping and allow the liens of secured creditors to "ride through" in a chapter 11 bankruptcy if they have not participated in the chapter 11 case in any way, despite the language of section 1141(c) of the Bankruptcy Code, which provides that "except [as] otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors . . ." *Acceptance Loan Co., Inc. v. S. White Transportation Inc. (In re S. White Transportation, Inc.*, No. 12-60648 (5th Cir. Aug. 5, 2013).

- Given such decisions regarding both lien-stripping and liens ride through chapter 11 cases—and the fact that the *Caulkett* decision is itself silent as to lien-stripping in the chapter 11 context—there are unlikely to be any material changes in the chapter 11 treatment of underwater liens in the wake of *Caulkett*.