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Alert

Priming DIPs: The New Normal?

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

Current Law

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

To support a proposed Priming DIP Loan, debtors typically argue that the secured creditor is adequately protected against any erosion of its collateral value by the existence of an "equity cushion" — the amount by which the collateral value exceeds the amount of the primed secured claim. *See In re YL West 87th Holdings I LLC*, 423 B.R. 421, 441 (Bankr. S.D.N.Y. 2010) ("The exist[ence] of an equity cushion seems to be the preferred test in determining whether priming of a senior lien is appropriate under section 364.") (internal quotations omitted); *Wilmington Trust Co. v. AMR Corp.* (*In re AMR Corp.*), 490 B.R. 470, 478 (S.D.N.Y. 2013) ("[T]he existence of an equity cushion can be sufficient, in and of itself, to constitute adequate protection."). The equity cushion is generally expressed as a percentage of the secured debt to

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[1] *See* our Dec. 8 *Alert*, "ABI Commission Report: Highlights of Proposed Chapter 11 Reforms."

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

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

Proposal

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

The practical consequences of the proposed changes are significant. Tying a secured lender's right to adequate protection to the foreclosure value of the collateral will make it materially easier for debtors to obtain court approval of Priming DIP Loans or the non-consensual use of cash collateral. So long as the going-concern value of the debtor's business (which could ultimately be realized in a later 363 sale

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

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

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or in connection with a reorganization plan) is high enough to create a sufficient equity cushion in excess of the collateral's foreclosure value, a debtor can obtain court approval of a Priming DIP Loan.

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

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

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

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

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

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

Conclusion

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

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

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