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Alert

Update on Reorganization Financing

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Reorganization or debtor-in-possession ("DIP") financing has become an increasing source of litigation. As shown in the recent case summaries below, courts are apparently becoming more sensitive to the rights of preexisting lenders. For a more detailed analysis of the law, e-mail us for a copy of our "Business Reorganization Financing" outline.

1. District Court Vacates Bankruptcy Court Superpriority Cash Collateral and Financing Orders that Primed Mechanics Liens

The United States District Court for the Southern District of Florida, on July 14, 2010, effectively vacated cash collateral and financing orders that enabled term loan lenders ("Term Lenders") to prime the liens held by mechanics lienors ("Statutory Lienholders"). See *In re Fontainebleau Las Vegas Holdings, LLC,* 434 B.R. 716, 759-60 (S.D. Fla. 2010). According to the District Court, the "bankruptcy court [had] erred in entering [these priming] orders over the Statutory Lienholders' objections." *Id.* at 759. It also failed "to ensure that the Statutory Lienholders' interests were adequately protected" when permitting the debtor to use cash collateral to pay the Term Lenders and professional fees. *Id.* In remanding to the bankruptcy court, the District Court directed it to "craft a remedy consistent with this Order . . . . Although the bankruptcy court cannot recover all the funds, it may and must recover the funds distributed to the Term Lenders, Examiner and the professionals pending a determination of the issue of priority [between the Statutory Lienholders and the Term Lenders] — not to exceed any amount the Statutory Lienholders have requested." *Id.* at 760.

Facts
The Chapter 11 DIP, a resort developer, held cash subject to the liens of both the Term Lenders and Statutory Lienholders. While the Term Lenders and Statutory Lienholders litigated over the priority of their liens, the bankruptcy court authorized the DIP to use cash collateral to maintain the project and pay administrative expenses, including the fees of an examiner. The bankruptcy court's cash collateral orders "deemed" that the DIP had repaid the cash to the Term Lenders and reborrowed it from them under Bankruptcy Code (the "Code") § 364(d), in order to grant the Term Lenders a priming lien on the project, with the Statutory Lienholders being subordinated. *Id.* at 725-26. These orders also required any third party DIP loan proceeds be used, first, to repay the Term Lenders the amount of cash collateral used by the DIP. Use of the cash collateral was necessary for administration of the Chapter 11 case, but there was no protection in the cash collateral orders for protection of the Statutory Lienholders' interest in the project if the court later determined that their liens had priority over the liens of the Term Lenders. A good-faith lender subsequently advanced new funds to the DIP, who used the loan proceeds to pay the Term Lenders pursuant to the terms of the cash collateral orders.

Court May Not Grant Priming Liens for Use of Cash Collateral
According to the District Court, the bankruptcy court's grant of priming liens to the Term Lenders for the DIP's use of cash collateral was not "authorized" under "the plain language" of Code § 364(d)(1): "The court, after

notice and a hearing, may authorize the *obtaining of credit* or the *incurring of debt* secured by a senior or equal lien on property . . . ." *Id.* at 757 (emphasis in original). "By their express terms, Sections 364(c) & (d) apply only to future -- i.e., post-petition-extensions of credit." *Id.* (citing *In re Saybrook Mfg. Co.,* 963 F.2d 1490, 1495 (11th Cir. 1992)). The Term Lenders here had failed to "provide future or post-petition extensions of credit." 434 B.R. at 758. Instead, the DIP merely "used cash collateral on which the Term Lenders" held a lien. Unlike a loan of new money from a third party, the DIP was "not trying to induce the Term Lenders to undertake risks inherent in providing postpetition financing to the estate" but was, instead, "trying to induce the Term Lenders to consent to the [DIP's] use of the cash collateral, maintain the status quo, or both." *Id.* There is simply no way for a lender to obtain a priming lien without advancing new money. Merely consenting to the use of cash collateral will not suffice, and the bankruptcy court's "deemed" new loan did not work. The DIP was required to provide the Term Lenders with adequate protection for the use of cash collateral, but the District Court found that "[n]othing in the Bankruptcy Code . . . appears to authorize a bankruptcy court to prime a secured creditor as a kind of adequate protection for the use of cash collateral." *Id.* In effect, the District Court rejected the bankruptcy court's ignoring of the Statutory Lienholders' property interests, the language of the Code, and applicable case law, and found that the bankruptcy court had erred in authorizing the use of the Term Lenders' cash collateral on a priming basis, and in failing to ensure that the Statutory Lienholders interests were adequately protected. *See id.* at 759.

2. Bankruptcy Appellate Panel Bars Use of Postpetition Rents to Pay Chapter 11 Administrative Expenses

The Bankruptcy Appellate Panel ("BAP") for the Sixth Circuit held on Dec. 23, 2010, that a Chapter 11 DIP had improperly sought to grant, as adequate protection, a replacement lien in after-acquired rents to its under-secured lender when the lender already had a prepetition lien on those rents. *See In re Buttermilk Town Center LLC*, 442 B.R. 558, 567 (BAP. 6th Cir. 2010). Reversing the bankruptcy court on this point, the BAP held that the non-consenting secured lender was not adequately protected by a purportedly new security interest in rents, over which it already had an independent security interest, in exchange for the DIP's use of cash collateral (*i.e.,* the rents). *See id.* at 566-67. Thus, a non-consenting secured lender must receive more than a replacement lien on previously encumbered rents if the DIP wishes to use that cash collateral to pay administrative expenses in the reorganization case (*e.g.,* salaries and legal fees). Significantly, the DIP in that case, the owner and operator of a commercial real estate development, had no equity in the encumbered real estate.

The lender, in the first instance, had unsuccessfully argued that the debtor had assigned the rents to it and that the rents were not even property of the estate. *Id.* at 562 (citing *Jason Realty, L.P. v. First Fidelity Bank, N.A.,* (*In re Jason Realty, L.P.*), 59 F.3d 423 (3d Cir. 1995) (rent assignment absolute under New Jersey law)). The BAP affirmed the bankruptcy court's holding, however, that the rents were, in fact, part of the debtor's estate under applicable Kentucky law. Although the lender argued that the language of the loan documents showed an absolute assignment, the BAP found the cited language to be "isolated" when the rent assignment agreement was read as a whole. *Id.* at 564. According to the BAP, the rent assignment showed that the parties intended the rents to serve only as "additional security." *Id.* Aside from the debtor's right to collect the rents, the lender could only apply those rents to reduce the underlying obligation of the debtor to the lender. *Id.* at 563. Most significant, the rent assignment agreement automatically terminated when the underlying debt had been satisfied. *Id.* In any event, the BAP found that, according to the Sixth Circuit, Kentucky law treated a rent assignment as secondary security. *Id.* at 564 (citing *Green v. Vanston Bondholders Protective Committee* (*In re American Fuel & Power Co.*), 151 F.2nd 470, 481 (6th Cir. 1945)).

3. District Court Affirms Bankruptcy Court's Denial of Motion for Use of Cash Collateral

The United States District Court for the Eastern District of Pennsylvania, on Jan. 20, 2011, held that a bankruptcy court had properly denied a DIP's motion for use of cash collateral because the DIP had been unable to provide the lender with adequate protection. *See Marcus Lee Associates L.P. v. Wachovia Bank* N.A., 2011 WL 206126 at *2 (E.D. Pa. Jan. 20, 2011). After a two-day evidentiary hearing, the bankruptcy court had been "unable to determine the *current value* of the [debtor's real property . . . .]", reasoning that "there clearly [was] value to the raw land and in the 19 units [but that the DIP had] failed to provide the Court with a non-speculative basis for determining an actual current value of such assets" (emphasis in original). *Id.* Moreover, the "future value of the land and 19 units [was] the **only** evidence in the record before the Court

on . . .value . . . ." (emphasis in original). *Id.* The DIP ultimately established only $950,000 in current value of the real property based on the existence of two model homes and an additional $300,000 in cash collateral. *Id.* The lender was owed more than $5.5 million. *Id.* According to the District Court, the Third Circuit had "reject [ed] the notion that development property is increased in value simply because a debtor may continue with construction which might or might not be profitable." *Id.* (citing *In re Swedeland Dev. Group*,16 F.3d 552, 566 (3d Cir. 1994) (*en banc*) (prepetition secured lenders owed more than $36 million, but their collateral worth only $18.495 million; proposed DIP financing would have subordinated them further with no protection against or compensation for this erosion of their collateral value)).

4. Court Limits Use of Superpriority Loan Proceeds

The Bankruptcy Court for the Northern District of Illinois, on March 11, 2011, held that a Chapter 11 DIP could not use proceeds from a $4 million postpetition superpriority loan to pay for (i) unquantified consulting service fees; (ii) previously performed services; (iii) services providing no or unknown benefit to the debtor's estate; (iv) other expenses not shown to be necessary and reasonable; or (v) the reimbursement of an insider's expenses. *See In re Olde Prairie Block Owner, LLC*, 2011 WL 864924 at *13 (Bankr. N.D. Ill. March 11, 2011). Nevertheless, the court did grant the motion for a priming lien, authorizing the use of the loan proceeds "to the extent Debtor [had] not already obtained credit and to the extent the payee's services [would] provide a benefit to the estate." *Id.* at *12.

Facts
The single-asset real estate DIP sought court approval under Code § 364(d) for $4 million of superpriority postpetition financing to "fund steps to make its project more attractive to potential lenders and investors." *Id.* at *3. The DIP intended to use the loan proceeds for payment of, among other things, outstanding real estate taxes, certain real estate development and engineering consultants, and for previously incurred professional fees. *See id.* at *4-7. To secure the new loan, the lender would receive a superpriority priming lien on the debtor's assets — parcels of real estate in Chicago. *See id.* at *2.

To obtain a superpriority priming lien like the one here, the DIP had to show that (i) it was unable to obtain the financing elsewhere, and that (ii) it was "adequately protecting" the interest of the preexisting secured creditor who was being primed. *See* Code § 364(d). The debtor's prepetition secured lender held a claim of approximately $49 million, secured by the debtor's real property. During the case, the court found the real property to have a value of approximately $81 million, based on the "finding that the highest and best use of the property [would] be for a fine hotel." 2011 WL 864924 at *2 The DIP thus had an equity cushion of roughly $30 million. *See id.*

Equity Cushion Alone Not Enough for Priming Loan, but Can Be Adequate Protection
Despite the equity cushion, the court explained, "[i]t is not enough to rely on a large equity cushion resting on expert opinions." *Id.* at *9. "Given the inherent uncertainty of determining valuation through methods commonly used by experts in appraising real estate, some restraint is warranted in allowing priming liens based on equity cushions." *Id.* at *10. Further "[a] debtor's use of credit obtained through a priming lien must be likely to benefit the estate and improve the debtor's ability to reorganize." *Id.* at *9 (internal citations omitted). The prepetition lender had objected to the DIP's financing request, arguing that its interest was not "adequately protected" and, further, that the proposed use of the funds would not advance the debtor's reorganization.

The court first examined the prepetition lender's "adequate protection" argument. Relying on *In re Swedeland Development Group*, 16 F.3d 552 (3d Cir. 1994), the lender had asserted that "its interest cannot be adequately protected because there [was] no tangible evidence that the financing [would] actually increase value of Debtor's property." *Id.* at *10. But *Swedeland* was "not appropriate," reasoned the court, because the lender's interest was protected here by the substantial equity cushion although the "possible increase in [debtor's property] value [was] speculative and dependent on market factors." *Id.* According to the Court, "[a]n equity cushion is not a debtor's piggy bank", but a large equity can still constitute adequate protection to a secured lender. *Id.* at *11.

Future Benefit to Estate
More important, the court analyzed whether the debtor's proposed use of funds would benefit the debtor's estate. Most of the proposed expenditures met the judicially established "business judgment" standard because they would enable the DIP to pursue its development of a hotel. Certain of the proposed expenditures, however, were inappropriate because the DIP's borrowing "in exchange for a priming lien in order to pay past due expenses would be contrary to the plain language of the requirements under [Code] § 364(d)." *Id.* at *11. Thus, the court approved the debtor's financing request only to the extent that the estate would benefit in the future. *See id.* at *11-12.

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