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Trend Watch: The Safety Of Reorganization Financing

Law360, New York (July 09, 2012, 1:44 PM ET) -- Chapter 11 creditors' committees and debtors continue to challenge lenders' prepayment premiums, commitment fees and post-bankruptcy interest claims in reorganization cases. Nevertheless, courts regularly reject these challenges in well-reasoned decisions.

We focus here on two recent decisions: In re Fleetwood Enterprises Inc. (9th Cir. BAP June 5, 2012) (held, lenders' commitment paid by Chapter 11 debtors pursuant to court order not subject to "turnover") and In re Madison 92nd Street Associates LLC (Bankr. S.D.N.Y. June 5, 2012) (overruled debtor's challenges to lender's (a) prepayment premium and (b) calculation of post-petition, pendency interest).

Commitment Fee Not Recoverable

The debtors in Fleetwood Enterprises sought and obtained bankruptcy court approval of an interim debtor-in-possession financing arrangement over the creditors' committee's opposition.

Because the debtors proved without contradiction that the financing was the only credit available to fund their reorganization, the bankruptcy court granted their request under Bankruptcy Code ("Code") § 364(c)(1). The committee did not complain about the reduced interest rate on the DIP financing, but did object strenuously to the up-front $2.4 million commitment fee, arguing that it should not be "earned on receipt." Id., at *5.

In particular, other than to pay the commitment fee, the debtors never ultimately drew on the available credit line because they had withdrawn their financing motion after the court had entered an interim financing order, relying instead on the use of cash collateral to fund the Chapter 11 administrative costs. Id., at *4. The committee insisted, therefore, that lenders had received a "windfall."

But the lenders' counsel made it clear during the approval hearings that the financing was expressly contingent upon payment of the commitment fee (e.g., "no fee, no credit"). Id. The bankruptcy court received further evidence and heard testimony as to the absolute necessity for the financing in order to avoid a shutdown. Id.

Committee's Arguments: The committee later sought a turnover of the commitment fee, arguing that the debtors "received no discernable benefit in exchange for the $2.4 million paid to" the lender. Id., at *5. The committee also argued that the commitment fee was not entitled to an administrative expense priority because it was not "an actual and necessary expense of" the case, and that the order authorizing the commitment fee was subject to further review or modification. Id.

Lenders' Response: The lenders argued that (a) the court had "thoroughly considered" the commitment fee; and that (b) the undisputed evidence in the record showed that the commitment fee

was an express "precondition to the Lenders' agreement to extend financing." Id. Although the bankruptcy court conceded the commitment fee "resulted in a windfall to Lenders," it still denied the committee's turnover motion, reasoning, among other things, that its earlier decision approving the commitment fee had been expressly approved as part of its earlier order. Id., at *6.

Appellate Ruling: Affirming the bankruptcy court, the Bankruptcy Appellate Panel (BAP) stressed that the lower court had, after deliberation, authorized payment of the commitment fee. "[I]f an entity has previously obtained a bankruptcy court order authorizing it to retain the property in question, [Code §]542(a) will not require turnover of the property." Id., at *7, quoting 5 Collier, Bankruptcy ¶ 542.02, at 542-9 (16th ed. 2011). Moreover, the committee never showed that the bankruptcy court's "prior authorization [was] inappropriate for some legal or factual reason." Id., at *8.

First, "the bankruptcy court carefully reviewed the requirements of § 364 and the evidence used to support its [order] and concluded that Debtors needed the interim credit facility or risked going out of business; concluded that the DIP Credit Agreement provided the most viable lending package in comparison to other alternative credit facilities, if any; and concluded that Lenders had the financial means to perform under the DIP Credit Agreement ... and did perform on the Closing Date after being paid the Commitment Fee ..." Id.

Moreover, the bankruptcy court could not "remove a material part of an agreement over the objection of one of the parties and order the balance of the agreement enforced." Id., at *9. Indeed, the "lenders' good faith was not in question ..." Id.

The BAP rejected the committee's argument, based entirely on hindsight, that the commitment fee was not entitled to an administrative expense priority because of a purported lack of a direct and substantial benefit to the estate. "While recognizing that § 364(b) requires a finding that the debt was an actual, necessary cost and expense of preserving the estate, § 364(c)(1), which grants priority over § 364(b) claims, does not contain such a requirement." Id., at *10.

Thus, a "claim that has been granted such a priority [under § 364(c)] is not ... properly treated as an administrative expense, because it has priority over administrative expenses and permitted only if the debtor 'is unable to obtain unsecured credit allowable ... as an administrative expense' even though the plan of reorganization must provide for payment of the claim as a condition of confirmation." Id., at *11, quoting 3 Collier, Bankruptcy, ¶ 364.04[2](a), at 364-13) (16th ed. 2011).

Prepayment Premium and Post-Petition Pendency Interest Allowed

The bankruptcy court for the Southern District of New York, in Madison 92nd Street Associates, supra, rejected (a) the debtor's challenge to a $3.1 million prepayment premium and (b) the debtor's demand for a post-petition, pendency interest rate on the lender's foreclosure judgment at the federal judgment rate of approximately 0.2 percent, rather than the New York statutory rate of 9 percent. 2012 WL 1995129, at *1.

The debtor had the right to prepay the loan only after the 36th month under a mortgage on the debtor's hotel. Id. If the lender, however, had to accelerate the loan during the initial 36 months for any reason "other than casualty or condemnation," the debtor agreed to pay a 5 percent prepayment premium on the outstanding balance of the loan. Id. The debtor did not dispute its default and the lender's acceleration during the initial 36-month period.

After the debtor's default, the lender foreclosed in New York and ultimately obtained a consensual judgment on May 26, 2011. Id., at *2. The consensual judgment included the 5 percent prepayment premium. Id. Although the lender's foreclosure sale was automatically stayed upon the filing of the debtor's Chapter 11 petition, the debtor sold its hotel under a confirmed reorganization plan, with the lender's lien attaching to the sale proceeds. Id.

"[C]ontending that the prepayment premium should be disallowed and the post-petition interest rate

should be fixed at the federal judgment rate," the debtor objected to the lender's secured claim. Id.[1]

No Relitigation of Consent Foreclosure Judgment: The court first held that debtor's objection to the prepayment premium, a component of the lender's judgment, is "barred under the doctrine of res judicata" because "a consent judgment has the same res judicata effect as a judgment on the merits." Id. There was no dispute that the state court had jurisdiction to enter the judgment; the judgment included the 5 percent prepayment premium; the debtor was party to the state court foreclosure action; and the debtor had "expressly consented to the judgment." Id.

The debtor was not attempting to raise a "bankruptcy issue," but argued instead "that the prepayment premium [was] unenforceable under non-bankruptcy law." Id., at *3. It should have made that argument "before the state court," reasoned the court. Id. Because "the debtor consented to the inclusion of the prepayment premium as part of the [State court foreclosure] Judgment," it could not relitigate the issue in the bankruptcy court. Id.

Prepayment Premiums Enforceable in New York: The court further noted that, in any event, "prepayment premiums are generally enforceable under the New York common law 'rule of perfect tender in time.' This rule prohibits the prepayment of the loan under the rationale that the lender has the absolute right to receive the bargained-for income stream over the life of the loan." Id. Moreover, the loan agreement here clearly required "the payment of the prepayment premium even after default and acceleration," effectively making it a "liquidated damages clause." Id., at *4.

No Penalty: The court similarly rejected the debtor's characterization of the prepayment premium as an "unenforceable penalty." Id. Relying on state law, the court noted the debtor's failure to show that the lender's damages were "readily ascertainable or that the premium was conspicuously disproportionate to" the lender's losses when the parties entered into the loan agreement. Id., at *5.

"The prepayment premium was designed to compensate [the lender] for the lost stream of interest payments. [The lender's] damages would depend on future changes in interest rates, which were not readily ascertainable at the inception of the Loan Agreement. In addition, had the debtor actually prepaid the loan, [the lender] would at least have had the principal to invest elsewhere. However, the debtor did not pay the loan, and [the lender] lost the use of its money as well as its income stream." Id., at *5.

In short, the debtor provided "no persuasive justification for disturbing the bargain struck by the parties." Id.

New York Legal Interest Rate: The court further rejected the debtor's attempt to impose the lower federal judgment rate of interest on the lender's judgment. The lender was oversecured, and its right to post-petition pendency interest was governed by Bankruptcy Code § 506(b), which permits a lender to recover not only "interest on such claim," but also "any reasonable fees, costs, or charges provided for under the agreement or State statute ..." Id., at *5.

Although § 506(b) does not establish an appropriate interest rate, most courts "have concluded that the appropriate rate should be the one provided in the parties' agreement or for the applicable law under which the claim arose, the so-called contract rate of interest." Id., at *6. When an agreement fixes a rate, "courts have recognized a rebuttable presumption that the contract rate applies post-petition, subject to adjustment based on equitable considerations." Id.

The debtor failed to rebut the presumptive "contract rate." The lender was "not guilty of misconduct"; the statutory rate was not "a penalty"; the debtor was "liquidating," and will require no "fresh start"; and according to the debtor's own judicial admissions, it is unlikely that unsecured creditors would be prejudiced by the application of the New York statutory 9 percent rate of interest. Id., at *7.

Finally, in the court's view, the debtor "offered no justification for the use of the near-zero federal judgment rate as opposed to some other rate between the federal judgment rate and 9%." Id., at *8. As the court stated, although "equitable principles play a role in the selection of the appropriate

pendency interest rate under § 506(b), the ability to adjust the presumptive rate is quite limited, and in this case, missing." Id.

Accord, In re Urban Communicators PCS Ltd. P'ship, 394 B.R. 325, 338-340 (S.D.N.Y. 2008) (reversed bankruptcy court's holding that capped post-petition interest at 25 percent; although reduction of contractual post-bankruptcy interest might be appropriate when junior creditors are prejudiced, unsecured creditors here fully paid; when debtor solvent, courts reluctant to modify contract interest rate; no unfair windfall to equity; parties knowingly bargained for higher default rate; default rate not a penalty), citing Ruskin v. Griffiths, 269 F.2d 827, 832 (2d Cir. 1959); In re 400 Walnut Assocs. LP (E.D. Pa. June 7, 2012) (reversed bankruptcy court's holding that capped pre-bankruptcy interest; "an equitable analysis does not govern whether prepetition default interest is allowable"; "loan documents and applicable state law " govern); In re 785 Partners LLC, 470 B.R. 126, 134-36 (Bankr. S.D.N.Y. 2012) (oversecured creditor's claim continued to accrue default rate of interest; no inequitable penalty; but late premium excluded by default interest).

Perspective

Fleetwood and Madison 92nd Street are hardly aberrational. For at least the past 10 years, appellate courts have overturned lower court decisions purportedly relying on equitable principles to deny lenders their contractual rights.

In Gencarelli v. UPS Capital Business Credit, 501 F.3d 1,8 (1st Cir. 2007), the First Circuit, for example, held that an oversecured creditor holds at least an unsecured claim for contractual prepayment penalties against a solvent debtor, noting that it was resolving "a difficult question that has significant ramifications for the commercial lending industry." It was irrelevant, reasoned the court, whether the prepayment penalty is unreasonable or entitled to secured lender status under Code § 506(b), so long as the penalty is valid under applicable state law.

The individual Chapter 11 debtor in Gencarelli and his wholly owned company had entered into two pre-bankruptcy loan agreements each containing a prepayment penalty clause. After the sole shareholder and his corporate entity filed Chapter 11 petitions, the corporate debtor sold all of its assets, resulting in proceeds sufficient to pay all creditors in full plus interest, with a multimillion dollar surplus for the sole shareholder debtor. Id. at 3.

The lender asserted a secured claim against the corporate debtor for the full amount of its loan, plus the prepayment penalty called for in the loan agreement. Although the debtor conceded liability for the loan balance, including interest, it objected to the prepayment penalty as being unreasonable. The lower courts held that Code § 506(b) governed the issue, reasoning that an oversecured lender could only recover a prepayment penalty if it was reasonable. Id. at 3-4. The lender appealed.

The First Circuit reversed and remanded the case to the bankruptcy court for a determination of whether the lender's prepayment penalty was valid under applicable Rhode Island law. According to the court, Code § 502 governed the issue of allowability of a claim, but § 506(b) only addressed the secured priority status of a lender's "reasonable fees, costs or charges ..." Id. at 5-6. "Section 502, not 506(b), affords the ultimate test for allowability, and any claim satisfying that test is, at the very worst, collectible as an unsecured claim." Id.

"Policy" and "common sense" dictated this result, the court explained. Id. at 6-7.

First, unsecured creditors may recover their attorneys' fees, costs and expenses from the estate of a solvent debtor so long as they are permitted to do so by the terms of their contract and applicable non-bankruptcy law. Id. at 6, citing In re Dow Corning Corp., 456 F.3d 668, 683 (6th Cit. 2006). It would be absurd to disallow the very same type of claim held by an oversecured creditor: "... [I]t does not make sense that over-secured creditors should be penalized by disallowing those fees ... altogether—especially when unsecured creditors can collect them." Id. at 7.

Second, Congress probably never intended that debtors be able to avoid otherwise valid contractual obligations (e.g., prepayment penalties) by filing bankruptcy petitions and invoking § 506(b)' s reasonableness requirement to penalize an oversecured creditor. "Creating that kind of uneven playing field would be antithetic to the general policy of the Code, which strongly favors over-secured creditors." id. at 6.

The court relied heavily on the debtor's solvency. "Let's be perfectly clear. This is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations as long as those obligations are legally enforceable ..." Id. at 7. In a solvent debtor case, the bankruptcy court's role is to enforce the lender's contractual rights. Id.

This statutory interpretation is sound, and, as the court noted, is supported by cases in both the Eleventh Circuit (Welzel v. Advocate Realty Inc. (In re Welzel), 275 F.3d 1308 (11th Cir. 2001) (en banc)) (held, oversecured lender's claim for legal fees, enforceable under state law, may still be reviewed for reasonableness under § 506(b): any unreasonable fees treated as unsecured debt) and the Ninth Circuit (Joseph F. Sanson Inv. Co. v. 268 Ltd. (In re 268 Ltd.), 789 F.2d 674 (9th Cir. 1986) (same)).

See also General Elec. Capt'l Corp. v. Future Media Productions Inc., 536 F.3d 969, 972-75 (9th Cir. 2008) (reversing lower courts, held, oversecured creditor's claim entitled to "presumption in favor of loan agreement's default rate ..., subject only to reduction based upon any equities involved," consistent with "rule adopted by the majority of [other] federal courts ..."), citing In re Layman, 958 F.2d 72, 75 (5th Cir. 1992); In re Terry Ltd. Partnership, 27 F.3d 241, 243 (7th Cir. 1994); In re Walnut Assocs. (E.D. Pa. June 7, 2012) (loan documents and applicable state law govern).

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[1] For additional information about the treatment of prepayment penalties by bankruptcy courts, see "Treatment of 'Make-Whole' and 'No-Call' Provisions by Bankruptcy Courts," by Lawrence S. Goldberg and David M. Hillman published in Pratt's Journal of Bankruptcy Law (April 2011).

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