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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Proposals to Reform Chapter 11 Target Secured Creditors

Law360, New York (December 18, 2014, 1:22 PM ET) -- On Dec. 8, the American Bankruptcy Institute ("ABI") Commission to Study the Reform of Chapter 11 issued a 400-page report recommending wide-ranging changes to Chapter 11 of the Bankruptcy Code. The recommendations in the report are not tweaks to the Bankruptcy Code, but instead represent a drastic departure from what are today considered fundamental principles of bankruptcy law.

If enacted, the proposals would significantly impair the rights of secured creditors and materially increase the leverage of debtors and out-of-the-money stakeholders by, among other things:

- Forcing senior creditors to share the value of their collateral with out-of-the money stakeholders in circumstances where the senior creditors are not paid in full;

- Making it materially easier for a debtor to obtain priming DIP financing and nonconsensual use of cash collateral by only protecting a secured creditor to the extent of the "foreclosure value" of its collateral (as opposed to the going-concern value); and

- Making it easier for a debtor to confirm a cramdown plan over the dissent of a class of secured creditors by eliminating the requirement of an "impaired accepting class."

Secured lenders need to understand the impact of these proposals and the likelihood of congressional passage so that credit pricing can be appropriately adjusted to reflect these potential risks. Below is a summary of some of the more critical proposals (out of more than 200 recommendations) that target the rights of secured creditors.

DIP Loans

The report contains many proposals relating to postpetition financing. One of the most significant changes involves a change to the concept of "adequate protection," which would make it materially easier for debtors to obtain postpetition financing secured by a lien that primes an existing first lien lender ("priming DIP loan") and to use "cash collateral" without the consent of the affected secured creditor.
For purposes of determining "adequate protection," the proposal provides that a secured creditor's interest in the debtor's property should be determined based on the "foreclosure value" of such interest (as opposed to going-concern value). (Report, at 67). This change will have a material impact on secured lenders with blanket liens or who otherwise rely on the borrower's future cash flows as the primary source of repayment. This proposal would allow debtors to rely on a purported "equity cushion" (i.e., the difference between the going-concern value and the foreclosure value of the collateral) to adequately

protect the primed secured creditor for any erosion in collateral value resulting from the incurrence of a priming DIP loan or the use of cash collateral.

Lenders who expected to be paid from the future cash flows of the business may find their recoveries significantly impaired, especially if the restructuring fails or if the going concern value actually realized is insufficient to cover the priming DIP loan and the existing secured creditor.

Other proposals that would affect DIP financing include the following:

- No "rollups" (i.e., using DIP loan proceeds to pay down, in whole or in part, prepetition secured claims) unless: (1) the DIP facility is provided by new lenders who do not hold the prepetition debt that will be paid down; or (2) the DIP lender extends "substantial new cash" and provides "more financing on better terms than alternative facilities offered to the debtor" (Report, at 73); and if rollup is permitted, it cannot be effectuated until the final financing order. (Report, at 80).

- No DIP lien or DIP claim or adequate protections liens on avoidance actions or their proceeds. (Report, at 68 and 73).

- No case "milestones, benchmarks, [or] similar provisions" during the first 60 days (e.g., deadlines to conduct a sale, obtain entry of an order approving bid procedures or obtain approval of plan support agreement). (Report, at 73).

- No waiver of Section 506(c), which allows a DIP/trustee to surcharge a lender's collateral. (Report, at 226).

- No waiver of Section 552(b), which allows the court to "limit or terminate" a "creditor's prepetition lien on postpetition property of the estate." (Report, at 231); and

- No lien or claim acknowledgements in interim financing orders. (Report, at 80).

Section 363 Sale of "Substantially All Assets"

The report includes proposals that substantially change the current law regarding Section 363 sales, the most significant of which is a requirement that senior creditors share collateral value with out-of-the-money stakeholders even when the value of that collateral is not sufficient to pay the secured creditor in full.

Out-of-the-money stakeholders (referred to as the "immediately junior class") would be entitled to a portion of the sale proceeds on account of "the future possibilities" that the "junior class might have been in the money or received a greater recovery if the firm had been valued at a later date," which is referred to as the "redemption option value." (Report, at 208).

The redemption option value payable by the senior class to the immediately junior class equals the "value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price [which equals 'the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor'] and a duration equal to three years after the petition date." (Report, at 219).

The redemption option value would be valued "using a market-based method such as the Black-Scholes model … ." (Report, at 221). The "bottom line implications" of this rule would be that "where the senior class distribution" results in close to payment in full, the immediately junior class is likely to be entitled to some redemption option value. On the other hand, where the senior class is deeply impaired," the immediately junior class" is likely to be entitled to receive little or nothing." (Report, at 222). The "immediately junior class" forfeits this premium if it objects to the sale. (Report, at 209).

Other material proposals affecting the section 363 sale process include a provision that would prohibit a sale of substantially all of a debtor's assets in first 60 days of the case unless the debtor can show "by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during the 60-day period." (Report, at 83).

Another sale-related proposal provides that creditors must be afforded "at least the same level of protection" in the section 363 sale process as they enjoy in the plan confirmation process. (Report, at 206). This means that the bankruptcy court must find by a "preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements" (Report, at 201):

- Sale must comply with all applicable provisions of the Bankruptcy Code (comparable plan provision found in Section 1129(a)(1));

- Proponent of the sale complies with applicable provisions of the Code (comparable plan provision found in Section 1129(a)(2));

- Sale was proposed in good faith and not by any means forbidden by law (comparable plan provision found in Section 1129(a)(3));

- All payments made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses must be approved by the court as reasonable (comparable plan provision found in Section 1129(a)(4)); and

- Sale proceeds (which are likely to be principally proceeds of the secured lender's collateral) must be reserved by the debtor in an amount sufficient to pay all allowed administrative expenses through the sale closing date (comparable plan provision found in Section 1129(a)(9)(A)).

Reorganization Plans

The report seeks to modify the current requirements to confirm a plan, including the elimination of the current confirmation requirement that any plan must be accepted by at least one impaired accepting class. (Report, at 257). The elimination of this confirmation requirement would make it easier for debtors to confirm a "cramdown" plan.
Additionally, the concept of "redemption option value" (discussed in context of Section 363 sale) would also apply in context of plan confirmation unless the immediately junior class challenges the enterprise valuation used to determine the redemption option value. (Report, at 207, 209).

Other plan-related proposals in the report include (i) linking the cram down rate of interest to a market rate of interest (Report, at 234); (ii) prohibiting "class-skipping" gift plans (Report, at 237); (iii) establishing a standard for nonconsensual third-party releases (Report, at 252) and exculpatory provisions for parties participating in Chapter 11 cases (Report, at 250); and (iv) adopting a one creditor, one vote" rule, which would "aggregates all claims in a particular class held by an entity and its affiliates that are subject to common investment management." (Report, at 257).

Intercreditor Agreements

The report also includes proposals that would nullify two provisions in intercreditor agreements. These proposals would render unenforceable: (1) any waiver, or assignment, of the right to vote on a plan (Report, at 261); and (2) any waiver by a junior creditor of its right to provide nonpriming DIP financing (Report, at 73).

Conclusion

The ABI report includes a host of changes that, if enacted into law, would significantly impair the recoveries of secured creditors and would represent a dramatic departure from the existing law.

—By David M. Hillman and Adam C. Harris, Schulte Roth & Zabel LLP

David Hillman is a partner in Schulte Roth & Zabel's New York office, where he practices in the areas of corporate restructuring and creditors' rights litigation, with an emphasis on the representation of secured and unsecured creditors and other parties in Chapter 11 bankruptcy cases.

Adam Harris is a partner in the firm's New York office, where he is chair of the Business Reorganization Group and a member of the firm's Executive Committee.

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