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Client Alert

Current Issues Relevant to Our Clients

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The ABI Commission on Reform of Chapter 11 Issues Final Report: What Secured Creditors Need to Understand

First of a Series of In-Depth Discussions of Key Issues

Last week, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the "Commission") released its Final Report and Recommendations (the "Report") for amendment to the current Bankruptcy Code. The proposals contained therein are significant, and on the whole, largely harmful to the rights of secured creditors. As we have indicated in our prior client alerts published in 2014, the Report is only the latest salvo in the continuous onslaught against secured creditors' rights that has been evident for the last several years. This is our first in a series of client alerts covering a number of the most impactful issues.

The proposals face a long path before becoming law and even the ABI does not believe that any legislation would be enacted prior to 2018. Nonetheless, the ABI is an important voice and the ABI will begin lobbying Congress in early 2015. More importantly, even prior to enactment of any amendments, it is likely that certain parties will seek to utilize many of the policies and recommendations contained in the Report in order to influence courts. As we have seen over the recent past, some judges may be moved by such arguments.

It is therefore critical for all secured creditors to understand the proposed amendments and their impact on secured credit. As such, beginning this week and continuing over the next several weeks, we will publish a weekly client alert containing an in-depth analysis of certain key provisions that are likely to significantly affect the rights of secured creditors. Among the topics to be discussed will be:

Redemption Option Value and Asset Sales – Among the most troubling of the proposals is what the Report deems the "Redemption Option Value." This proposal would alter the current distribution scheme contained in the Bankruptcy Code, centered around the absolute priority rule, and require senior creditors to "gift" a portion of the debtor's enterprise value to the next junior class of creditors in connection with a sale of assets or plan of reorganization. This proposal would likely result in increased litigation over the appropriate valuation of the redemption option value payable to the junior class and increase the cost of funding chapter 11 bankruptcy cases for all borrowers. The Report also proposes requiring a 60-day moratorium on most asset sales following a bankruptcy filing and instituting a higher standard to approve assets sales. Rather than serving as helpful reform, this proposal appears designed to create additional inter-creditor conflict, and only likely to make cases longer and more expensive by forcing secured creditors to finance cases for a longer period.

Adequate Protection and DIP Loans – Similarly troublesome for secured creditors is a proposal which would compel courts to use "foreclosure value" of the collateral rather than going concern value in determining whether adequate protection is due and owing to secured creditors at the outset of a bankruptcy case. Using foreclosure value will significantly reduce secured creditors' protections against the use of their collateral by debtors to finance a bankruptcy proceeding without the secured creditors' consent. The Report also proposes to prohibit DIP loans from containing milestones or benchmarks requiring the debtor to take certain actions in a bankruptcy (such as filing a plan or commencing a sale process) or from containing representations regarding the validity of liens within 60 days of the filing of a petition. DIP loans would be prohibited from containing "rollups" of pre-petition debt into DIP loans by pre-petition lenders unless the lender extends substantial new credit on terms better than any alternative party and the court finds the rollup is in the best interests of the estate. The Report also suggests that intercreditor agreement provisions restricting the ability of junior creditors to provide DIP financing be made unenforceable. Such alterations to the current landscape would likely materially disadvantage secured creditors by both: (i) taking away much of their protection against depreciation in the value of their collateral during the bankruptcy case, and (ii) limiting their ability to quickly and efficiently secure a path to exiting bankruptcy.

Section 552 and the "Equities of the Case" Exception – In an important recent decision,[1] junior creditors were successful in using the "equities of the case" exception of § 552(b) to cut off lenders' pre-petition liens on any increased value generated post-petition by arguing that the debtor's post-petition use of unencumbered property, including "time, effort, and expense by the Debtors' estates," had enhanced the value of the prepetition collateral. The effect was to reduce the overall value allocated to the prepetition liens in connection with the post-petition proceeds from an asset sale. Despite this case, § 552 has been of limited effect as debtors typically waive their rights under this provision as part of an adequate protection or DIP package given to the prepetition lenders. In a blow to secured creditors, the Report now recommends that such waivers be prohibited,[2] and that the evidentiary standard required to demonstrate post-petition enhancement of prepetition collateral be lowered. If enacted, the proposal would likely lead to increased litigation over the scope of pre-petition liens and post-petition enhancements as well as higher capital costs associated with uncertainty of the value of lenders' post-petition liens.

Eliminating the Accepting Impaired Class Requirement – Section 1129(a)(10) currently protects secured creditors by making it more difficult to approve cramdowns, i.e., a plan of reorganization over the objection of the secured lender, without the consent of at least one "accepting impaired class." The Report proposes eliminating this requirement, thereby making it easier for debtors to cramdown plans over the objection of secured creditors that have unsecured "deficiency claims."

Changes to the Safe Harbor Provisions With Respect to Derivatives and Similar Financial Contracts – Arguing that the Bankruptcy Code's safe harbors are now too broad in scope, the Report recommends revisions to the Bankruptcy Code in order to align the safe harbors to cover only the kinds of agreements protected prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Alternatively, the Report recommends that the safe harbor be amended to exclude repurchase agreements that are, in substance, committed financing arrangements for mortgage loan portfolios. The Report also recommends amendments to the treatment of "ordinary supply contracts" (contracts that are entered into in the ordinary course of business between non-financial sector firms), private leveraged buy-outs and walkaway clauses.

While most of the recommendations largely seek to increase the rights of junior creditors at the expense of senior creditors, there are, fortunately a few bright spots. Among these are: (i) secured creditors should receive the "going concern" value of their collateral rather than its liquidation value upon a sale or plan of reorganization; (ii) courts should not apply the "prime plus" formula adopted by the Supreme Court in *Till* and applied in the chapter 11 context in the recent *Momentive* decision (whereby it was used to substantially reduce the senior secured creditors' recoveries), recommending instead that secured creditors be entitled to a market rate of interest on replacement notes in a cramdown context; and (iii) secured creditors be entitled to credit bid the full amount of their claim regardless of the effect such bids have on other bidders (contrary to the holding in *Fisker*). Importantly, the Report also does not place any significant restrictions on claims trading.

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1. *In re Residential Capital, LLC*, 501 B.,R. 549 (Bankr. S.D.N.Y. 2013)
2. The Report similarly recommends that debtors should not be permitted to waive their rights under § 506(c), which provides debtors with the ability to recover from secured creditors' collateral the necessary costs and expenses of preserving or disposing of that collateral.

For More Information

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