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Client Alert

Current Issues Relevant to Our Clients

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Your Blanket (Lien) May Have Holes: Proposed Amendments May Further Erode Secured Lenders' Rights

Fourth in a Series of In-Depth Discussions of Key Issues on the ABI Commission Final Report on Chapter 11 Reform

This is the fourth installment of Chapman and Cutler LLP's discussion of the proposals contained in the American Bankruptcy Institute's ("ABI") Final Report and Recommendations (the "Report") to amend the Bankruptcy Code. As discussed in the previous three installments, many of the proposals contained in the Report will have significant and negative implications for secured creditors. This is also true with respect to the Report's proposed amendments to § 552 of the Bankruptcy Code. This section establishes the extent and continuation of a creditor's prepetition security interests in a borrower's property following the commencement of a bankruptcy proceeding. The Report's proposed amendments to § 552 would codify a number of recent bankruptcy court decisions that have significantly damaged secured creditors' rights by limiting the reach of their prepetition liens on debtors' postpetition assets, thereby drastically reducing secured lenders' recoveries. Moreover, the proposed amendments go even further -- by advocating that debtors be prohibited from waiving rights related to § 552 and lowering the related burden of proof, thereby making the importance of such rulings even greater. The decisions regarding § 552 (and the ABI's attempt to codify such decisions and limit the ability to mitigate such rulings) therefore pose a significant threat to secured creditors and should be carefully watched by all parties.

Section 552 and the Value of Secured Creditors' Collateral

Secured creditors have long assumed that if they possess a blanket lien on all of a borrowers' assets, such liens will capture a debtor's overall enterprise value, whether such value is created prior to or after the commencement date of a borrower's bankruptcy proceeding (the "*Petition Date*") pursuant to a chapter 11 reorganization or § 363 sale, up to the full face amount of their outstanding debt and all applicable interest and fees. For example, imagine the case of a loan to a distressed restaurant chain that is secured by a first priority blanket lien on all assets, including all equipment, food inventory and revenues. Typically, the lender's recovery in bankruptcy would not be limited to the liquidation value of the specific collateral, but rather, dependant upon the overall enterprise value of the business. Following any bankruptcy, creditors holding this debt would typically expect that any turn-around in the debtor's business, through the restructuring of its junior debt and rejection of unfavorable contracts, would significantly increase the value of the secured debt, allowing such creditor to capture any upswing in the debtor's overall value up to the amount of its debt.

It is only through the application of § 552, however, that prepetition secured creditors liens on collateral apply to a debtor's postpetition assets following a bankruptcy filing. This section, as currently enacted, cuts off all secured creditors' prepetition liens on property acquired by a debtor postpetition ***unless*** the applicable prepetition credit agreement includes a specific provision providing that the "***proceeds, products, offspring or profits***" of such prepetition property will continue to be subject to the prepetition lien following a debtor's bankruptcy filing.[1] This section also includes an important caveat to this rule, permitting courts discretion to find that the "equities of the case" mandate that prepetition liens should not attach to the debtor's postpetition property. As drafted, § 552 is therefore critically important to not only the continuation of prepetition liens to postpetition collateral following a bankruptcy filing, but also to the overall value of secured creditors' debt.

Recent Legal Challenges to the Scope of § 552

Secured creditors' ability to use § 552 to extend their prepetition liens to postpetition collateral has, however, recently come under attack. In a number of important cases, unsecured creditors have been able to persuade

certain bankruptcy courts to cut off secured lenders' rights to postpetition assets that most lenders assume are part of their overall collateral package, such as fixed assets and revenue. These decisions have largely hinged on the court's finding that postpetition acquired assets did not fall within the exact definitions of "proceeds, products, offspring, or profits."[2] For example, *In re Las Vegas Monorail Co.*,[3] the court took great lengths to find that secured lenders' prepetition liens in "contract rights" and "net project revenues" did not cover a debtor's postpetition income stream.[4]

Junior creditors have also used § 552's "equities of the case" exception to convince courts to find that a secured lender is only entitled to retain its liens on the proceeds of its prepetition collateral so long as no unencumbered assets have been used by a debtor to enhance or protect the secured assets at issue. In making this finding, courts have undertaken detailed examinations of the debtor's postpetition expenditures, tracing the source of funds utilized by the debtor during its bankruptcy case. Thus, where a secured creditor has a lien on all assets and no unencumbered assets are used to protect or improve a debtor's secured collateral, courts have allowed prepetition liens to attach to postpetition proceeds of such collateral and held that the "equities of the case" exception did not apply. For example, in *In re Laurel Hill Paper Company*,[5] the debtor used postpetition financing to pay the estate's expenses as well as all expenses related to a sale of certain assets secured by the lender's liens. The court found that, because no postpetition expenses were paid using unencumbered funds (rather only the postpetition funds received as part of the postpetition financing were used), the secured lender retained its liens over the postpetition collateral, was entitled to the all of the remaining proceeds from the sale (after repayment of the postpetition loan), and there was no support for an "equities of the case" award to the unsecured creditors.

However, where unencumbered assets — including "soft assets" such as the debtor's postpetition services — are employed to enhance or improve prepetition collateral, courts have invoked the "equities of the case" exception and chosen not to extend the prepetition liens to cover postpetition assets. For instance, in *In re Cafeteria Operators*, *L.P*,[6] secured lenders of a restaurant chain possessed a blanket lien on all of the debtors' assets and proceeds thereof. The secured lenders' collateral therefore included, among other things, the ingredients used in the food preparation, which can be secured by a filing under the Uniform Commercial Code. The lien did not, however, cover the labor of the debtors' workers — a soft asset for which it is impossible to obtain a security interest. The Bankruptcy Court held that while certain portions of the debtors' revenues were proceeds of the collateral (specifically those parts attributable to the inventory), the portion attributable to the labor was not "proceeds" of the lender's collateral. Thus, the Bankruptcy Court held that the value of the secured creditor's interest in the postpetition revenues should be limited to the value attributed to its prepetition inventory based upon the "equities of the case" exception to § 552(b)(1). The court reasoned that to grant a blanket lien on all cash generated postpetition would represent a windfall to the secured creditor, in the face of the debtors' utilization of estate resources, *i.e.* their employees' labor, to increase the value of the secured creditor's collateral.[7]

A similar result was reached in *In re Residential Capital*.[8] In that case, junior secured noteholders ("*JSNs*") contended that they were entitled to postpetition interest, among other things, because they were over-secured based on the value of their pre- and postpetition collateral. In addition to holding certain liens on prepetition collateral, the JSN security agreement granted them a wide-reaching lien on all proceeds, products offspring, rents, issues, profits and returns of and from, and all distributions on and rights arising out of any of the collateral described in the JSN Security Agreement. Based upon these liens, the JSNs argued that they were entitled to the full going concern value of certain assets that had previously been sold postpetition to third parties, including both the liquidation value of those assets as well as the proceeds in the form of goodwill over and above the liquidation value.

After reviewing various expenditures made by the debtors as well as the source of the funds used, the Bankruptcy Court found that the debtors had used unencumbered estate resources — both property not subject to the secured creditors' liens as well as the debtors' soft assets, consisting of "time, effort and expense" — to enhance the value of the assets, thus generating an increase in the goodwill associated with the sale. Finding that §552(b)(1) only applies to collateral acquired postpetition that is "directly attributable to prepetition collateral, *without the addition of estate resources,*" the Bankruptcy Court held that the JSNs had failed to meet their burden of establishing a lien on the goodwill portion of the amounts generated by the sale. Accordingly, the JSNs' claims were limited only to the liquidation value of their specific collateral and postpetition increases in goodwill were not attributed to the value of the JSNs' claims, thus prohibiting the JSNs from sharing in the overall postpetition increase in enterprise value.

As a result of these cases, secured creditors' recoveries have been limited to the value of the underlying collateral as of the petition date and the secured creditors' have not been able to share in postpetition increases in goodwill or overall enterprise value. While these cases are

problematic for secured creditors, they have not yet had a significant impact on secured creditor recoveries more broadly because lenders have, in most cases, required debtors to waive their rights to assert challenges to liens under § 552 as part of a postpetition financing package. However, the Report's recommended amendments seek to change this, thereby making the effect of these cases much more significant to all secured creditors.

The Commission's Proposal

First, the Report recommends that the recent jurisprudence regarding the "equities of the case" be codified into the Bankruptcy Code. If adopted, such recommendations would be problematic for secured creditors in that it would limit secured creditors' entitlement to postpetition proceeds of their collateral, including revenue and gains in overall enterprise value achieved after the commencement of a bankruptcy proceeding.

Perhaps more significantly, the Report goes even further than the current case law by proposing to lower the bar that a debtor must reach to show that the estate enhanced the value of the secured creditors' collateral for the purposes of § 552's "equities of the case" doctrine. The Commission asserts that a debtor should not be required to establish an actual expenditure of funds to evidence that the bankruptcy proceeding enhanced the value of the secured creditor's collateral using unencumbered assets. Rather, the Commission urges that a debtor should only be required to show evidence of any value provided, obligation incurred, or other action taken with respect to the secured creditor's collateral. Under the Commission's recommendation, a debtor could show evidence of the estate contributing value through evidence of the debtor's time, effort, money, property, other resources or cost savings.

Finally, the Commission recommends that § 552 be amended to prohibit a debtor from waiving its rights or entering into any agreement settling the value of a secured creditor's interest in the proceeds, products, offspring or profits of prepetition property. Under the Commission's proposal, debtors would be prevented from entering into any agreement (including a DIP financing agreement) that would limit a court's ability to make a determination based under § 552.

The Proposed Recommendations Will Have Negative Effects for All Secured Creditors

If enacted, these proposals would likely increase litigation costs of secured creditors (not to mention borrowing costs of borrowers) by encouraging junior creditors to challenge the liens of senior creditors as they relate to postpetition proceeds or value and requiring bankruptcy court judges to review each unique situation on a case-by-case basis, therefore creating greater uncertainty for secured creditors. Such uncertainty would be compounded by the Commission's proposed prohibition against waiving a debtor's rights under § 552 with respect to a secured creditor's collateral. The Report is even more troubling because when determining whether to limit a secured creditor's rights under the "equities of the case" doctrine, the Report would permit a debtor to show evidence that *any value* was provided — whether through time, effort, money, property, other resources, or cost savings — based on the facts underlying the bankruptcy proceeding.

Conclusion

The amendments to the Bankruptcy Code suggested in the Report, along with developing case law, could turn § 552 into a powerful weapon by which value may be wrested from secured creditors. As we have discussed in our prior client alerts, these proposals are not the law at this time, but may be influential to bankruptcy court judges. Further, if enacted, secured lenders would have to significantly reassess their recovery expectations in the event of default. Therefore, secured lenders and their advisors must maintain a vigilant eye on any efforts to implement these proposed reforms.

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1 11 U.S.C. § 552(a) & (b)(1).

2 Importantly, none of these terms are defined in the Bankruptcy Code.

3 429 B.R. 317 (Bankr. D. Nev. 2010).

4 *See also*, *In re Premier Golf Properties, LP*, 477 B.R. 767, 774-75 (B.A.P. 9th Cir. 2012) (upholding bankruptcy court finding that a lender's lien in a debtor golf club operator (covering the debtor's personal property, general intangibles, license fees and "all proceeds thereof," and real estate, all rents, profits, issues, and revenues from the real property) did not extend to postpetition green fees or driving range fees); *In re Skagit Pacific Corp.*, 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004) (holding that despite prepetition liens on accounts receivable, postpetition accounts receivable were not included within the definition of "proceeds" where the revenue was derived, in part, from postpetition services performed by the debtor).

5 393 B.R. 89, 92-95 (Bankr. M.D.N.C. 2008).

6 299 B.R. 400 (Bankr. N.D. Tex 2003).

7 *Id*. at 410.

8 501 B.R. 549 (Bankr. S.D.N.Y. 2013).

For More Information

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