BANKRUPTCY UPDATE

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The Pendulum Swings Again:
The Assault on Secured Creditors

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What can lenders do about these rulings, which undermine their right to credit bid? At the outset, although it may provoke a controversy early in the case, pre-bankruptcy secured lenders that provide debtor-in-possession (DIP) financing or consent to debtors’ use of cash collateral will want the DIP financing or cash collateral order to preserve explicitly their right to credit bid should their collateral be sold pursuant to a Plan of Reorganization.

Note, this strategy has not yet been tested in court. However, the theory for upholding it would be that such a grant of rights to the DIP lenders is part of the consideration for the loan. This may be the right point in time for a secured lender to obtain such a concession, since the debtor will be eager to obtain DIP financing or avoid a fight over cash collateral. Secured creditors may also want to limit the amount of DIP financing they agree to provide, or the amount of cash collateral they authorize in order to keep debtors on short leashes and to help compel §363 sales (see discussion below), rather than see their funds used to provide fuel for a debtor planning to wage a confirmation battle with the lender. Lenders may also more readily file motions for relief from the automatic stay so that they can foreclose on their collateral in state court, and then credit bid pursuant to applicable state law.

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Lenders holding non-recourse debt will have to consider whether to make the so-called §1111(b) election. Though a full description of this option is beyond the scope of this article, the §1111(b) election permits lenders to waive their rights to an unsecured deficiency claim and instead retain a lien on their collateral for the full face amount of their claims. So, for example, a secured lender that is owed $50 million and whose collateral is currently worth only $40 million (but is expected to appreciate in the future), that has no recourse to a guarantor, can elect to waive its rights to its $10 million unsecured deficiency claim and instead retain a lien on the collateral as representing the full amount of its claim (i.e., $50 million).

This right to election is designed to protect non-recourse lenders that expect their collateral to appreciate in the years following plan confirmation by preventing them from having to cash out of their collateral at what might be a depressed value. If a secured lender makes this election, those seeking to cash lenders out at Plan confirmation would have to pay the secured lender the full face amount of its claim, regardless of the collateral’s actual value. So, for example, a secured lender that is owed $50 million and whose collateral is currently worth only $40 million (but is expected to appreciate in the future), that has no recourse to a guarantor, can elect to waive its rights to its $10 million unsecured deficiency claim and instead retain a lien on the collateral as representing the full amount of its claim (i.e., $50 million).
debtor-in-possession, but which were less broad than a sale of all of the assets.

Beginning in the 1990s, §363 became increasingly used as a quicker and less costly alternative to the Plan confirmation process to sell a distressed business, and “§363 sale motions” were increasingly filed together with bankruptcy petitions, with such sales being consummated within several weeks of filing. While some jurisdictions wrung their hands for a time over the rapidity of the process — often carried out before a creditors committee could get very deeply involved — the more popular jurisdictions such as Delaware and New York have gotten over any misgivings, and such cases have become commonplace, especially where debtors are quickly running out of cash.

Secured lenders typically supported the more efficient and cost-effective §363 sale process on its own merits. Now, in light of the recent troubling decisions, secured lenders will strongly prefer that any sale be carried out pursuant to §363, and not through Plan confirmation. This is because, while the Bankruptcy Code apparently (according to the recent court decisions) does not provide secured creditors the right to credit bid if the sale occurs through the Plan process, the Bankruptcy Code is more explicit in protecting lenders’ rights to credit bid in §363 sales. But that protection is not absolute since bankruptcy judges may deny secured creditors the right to credit bid “for cause.” An example of such a situation might be where the bankruptcy court determines that an undersecured creditor’s right to credit bid would deter potential buyers from bidding for the assets, or where the lender’s status as a secured creditor is the subject of a serious dispute.

If the Plan process cannot be avoided, secured lenders should consider asserting legal attacks to Plan confirmation that focus on the fairness of the business aspects of the involuntary modification of its claim that the debtor is seeking to impose. While it is often necessary to contest confirmation by focusing on valuation, that is a determination that is left to the discretion of the bankruptcy court, and it is typically very difficult to overturn on appeal an adverse valuation finding made by a bankruptcy judge. Instead, a secured lender may want to argue that the proposed plan that the debtor is seeking to “cram down,” does not meet the “fair and equitable” requirements of the Bankruptcy Code because the restructuring terms are truly unfair and inequitable, and therefore deficient as a matter of law, given the facts and circumstances of the particular case. Even if a secured creditor may rightfully be denied the right to credit bid that does not mean that the treatment afforded it under the debtor’s Plan satisfies the fair and equitable test.

For example, the net proceeds produced in the all-cash auction or private sale of the collateral may be too low, or it may be generally believed that the collateral has only temporarily depreciated and is likely to increase in value in the near future following Plan confirmation. To deprive a secured creditor that did not have the right to make a §1111(b) election of the right to credit bid under such circumstances might rightfully be viewed as unfair and inequitable. (Again, this theory has not yet been tested, and the results may vary from case to case.)

Secured lenders will also need to consider challenging a debtor’s Plan that provides for a sale of the debtor’s assets without permitting a credit bid, on the grounds that the secured lender is not receiving “the indubitable equivalent” of its secured claim. As the Third Circuit pointed out in the Philadelphia Newspapers decision discussed in Part I of this article, the consideration paid on account of the secured lender’s claim under the Plan may not mirror the net proceeds produced by the auction of the collateral.

The secured creditor will have to analyze what it is proposed to receive under the Plan, and decide whether it can establish that this consideration is unreasonably low compared to the value of its collateral at the time of Plan confirmation. This, of course, may open the door to a messy fight over valuation of the collateral, and so the cost of the litigation both in legal fees and in terms of possible detrimental effect upon the assets should be considered.