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BANKRUPTCY UPDATE

PART I OF II (PART II WILL APPEAR IN THE JULY/AUGUST 2010 ISSUE)

The Pendulum Swings Again: The Assault on Secured Creditors

BY PAUL A. RUBIN, ESQ. AND HOWARD BROD BROWNSTEIN, CTP

Recent court decisions may have seriously eroded secured creditors' rights. In this two-part article, a leading restructuring attorney has teamed up with a well-known turnaround professional to describe in Part I new challenges facing lenders, and in Part II to suggest strategies and tactics to help lenders protect themselves.

PAUL A. RUBIN
Partner, Restructuring & Bankruptcy Department, Herrick, Feinstein LLP

HOWARD BROD BROWNSTEIN
President,
Brownstein Corporation

Clarence Darrow said, "It is not the strongest of the species that survive, nor the most intelligent, but the one most adaptable to change." During the Bush Administration, the rights of creditors were strengthened, especially by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).1 But beginning with the run-up to the 2008 election, there has been a sea change in national sentiment, not only among the voting populace, but apparently among the judiciary as well.

In the midst of the current economic downturn, as if the risk and credit challenges for lenders were not difficult enough, a recent flurry of court decisions has challenged widely accepted assumptions regarding the rights and protections afforded to secured creditors in Chapter 11 cases. While courts may be striving to support companies seeking to rehabilitate themselves and emerge successfully from Chapter 11, and to prevent the job losses that would inevitably result from business failures, the pendulum definitely is swinging in favor of debtors and reducing the rights of secured creditors. The foundation for lenders' underwriting decisions in many common lending situations has clearly been affected. While there is a chance that future court decisions could limit the impact of the recent cases discussed below, for the time being, lenders should be forewarned and become forearmed, since their rights have been affected. The line of recent court decisions is ominous:

- *General Growth Properties*,[2] a New York bankruptcy case, involved hundreds of entities owning a myriad of real estate properties, as well as their parents and guarantors. In its decision, the bankruptcy court permitted healthy single asset real estate debtors to upstream to their corporate parent, excess cash flow that had been pledged to their secured creditors — that is, cash collateral — to support the operations of affiliated debtors that were cash-flow negative. That same court refused to dismiss as bad faith filings the Chapter 11 cases of special purpose, bankruptcy remote real estate borrowers whose independent managers were fired on the eve of the bankruptcy filings, and whose loans were not in default when the cases were commenced.
- The *TOUSA*[3] case, a Florida bankruptcy, involved a fraudulent conveyance action where the debtor's former lenders were required to disgorge over $420 million, and upstream guarantees and liens the debtor provided to its new lenders were invalidated. The loan documents in the case included "savings clauses," intended to reduce guarantees so as to protect against an attack on the basis of fraudulent transfer, (i.e., if the entity issuing the guarantee were thereby rendered insolvent). The court held that "savings clauses" in loan documents

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were unenforceable, and could not protect lenders from having to disgorge, as fraudulent transfers, hundreds of millions of dollars they had received as payments of principal, interest and professional fees owed to them pursuant to their loan documents.

- It is not often that bankruptcy court decisions from outside the mainstream jurisdictions of Delaware and New York make headlines. *Yellowstone Club*[4] was a Montana case involving a resort development, in which a creditors committee sued the lender that had arranged the financing, claiming that the lender had allowed the borrower to divert loan proceeds and that the borrower would likely be unable to repay the loan, all for the sake of enabling the lender to earn fees. In that case, the bankruptcy court ordered the rarely applied and draconian remedy of equitable subordination, in which a secured lender's claim, which normally has priority ahead of unsecured claims, is placed behind unsecured claims. Such action by a court is typically reserved for situations where the conduct of the secured creditor has been truly egregious, such as where a secured creditor has effectively controlled the business of the borrower, to the detriment of unsecured creditors. In this case, the Montana bankruptcy court equitably subordinated to the claims of unsecured creditors, a $375 million syndicated secured loan, based solely on the pre-bankruptcy conduct of the original lender/lead agent, which had sold virtually all of the credit to loan participants before the borrower filed for bankruptcy. This court decision is worrisome to lenders because it effectively holds that the lender loaned too much money to the borrower and made too much in fees (in the view of the court), such that the lender's behavior was egregious and its secured claim should be subordinated to the claims of unsecured creditors.

As if the above decisions by bankruptcy courts were not distressing enough for secured lenders, federal appellate courts have weighed in with decisions that are even more potentially threatening to the rights of secured lenders, due both to their content and because appellate decisions carry far more weight. This is because their rulings control all subsequent decisions of the bankruptcy and federal district courts in their respective circuits, and might persuade bankruptcy courts in other circuits to follow suit.

Among the most far-reaching decisions are those of the Fifth and Third Circuit Courts of Appeal, concluding that a secured creditor does not automatically have the right to credit bid whenever a debtor proposes to sell the pledged collateral in connection with a Chapter 11 Plan of Reorganization (Plan). These decisions do not appear to be anomalous, reached to address unusual or egregious facts, in which case one might expect that the decisions might have limited applicability to other circumstances. Rather, unless overturned by the U.S. Supreme Court, these rulings establish precedents that must be followed in certain jurisdictions (including bankruptcy courts located in Louisiana, Mississippi, New Jersey, Pennsylvania, Texas, and — most notably — Delaware), and which might well be followed in others.

Rather than serve to streamline the bankruptcy process or make it more predictable — virtues important to the use of bankruptcy reorganization as a tool for the rehabilitation of distressed businesses, these cases seem to invite increased litigation over plan confirmation, and to encourage bids from third parties that may expect the assets of debtors to appreciate. The ringing dissenting opinion from one of the appellate judges in the Third Circuit case, who was formerly a well-respected bankruptcy attorney in Delaware, warned that the consequences of the majority's holding "include upsetting three decades of secured creditors' expectations, thus increasing the cost of credit."

Accordingly, these holdings deserve special attention:

- *In Pacific Lumber*,[5] a Fifth Circuit case, the secured noteholders were owed approximately $740 million, of which about $510 million represented the judicially determined value of the collateral, (i.e., the secured portion of their claim). A creditor combined with a non-party to propose a Plan of Reorganization. Under this Plan, its proponents would obtain the noteholders' collateral, the noteholders would receive $510 million in cash for the secured portion of their claim, plus the proceeds of certain pending lawsuits commenced by the debtors, the value of which could be zero and in any event would not be determined for a long time, for their $230 million unsecured deficiency claims.

  The Texas bankruptcy court confirmed the Plan over the noteholders' objection based on expert testimony, but without conducting an auction or permitting the noteholders to credit bid for their collateral, as has long been a standard practice in such cases. The Fifth Circuit Court of Appeals then affirmed the decision of the bankruptcy court, ruling that the Plan could properly be confirmed, largely because the payment in cash to the noteholders of the judicially determined value of their collateral constituted what the Bankruptcy Code calls "the indubitable equivalent" of their secured claim. While on its face this does not appear to be an unfair result, secured creditors, such as the noteholders in this case, had hitherto almost always been given the opportunity to credit bid based upon the total amount of their claim, such bidding taking place in an auction process intended to produce the highest and best value offered for the debtor's assets. In this case, the bankruptcy court had substituted its own determination of value — albeit based upon evidence adduced in court — but without subjecting the assets to a market process.

  Furthermore, the bankruptcy court in *Pacific Lumber* was presumably acting to protect the rights of the very creditors who were objecting, seemingly ignoring basic tenets of bankruptcy law that parties know best what is in their own interests, and courts should therefore simply respond to parties' own submissions of what they want, subject to ethical and other basic considerations. Instead, the *Pacific Lumber* decision seems to focus on the technicality that, according to the Bankruptcy Code, the bankruptcy judge had the authority to do what he did, rather than focus on broader principles of fairness that are more traditional for bankruptcy courts as courts of equity.

From the perspective of lenders, these rulings spell real trouble, including the loss of influence or control over the sales process, reduced leverage in negotiations, and increased costs, delay and uncertainty of litigation over Plan confirmation.

- Even more troubling is the recent *Philadelphia Newspapers*[6] case, which has been much in the news recently, including in this publication.7 This case involved the award-winning daily newspapers in Philadelphia, *The Philadelphia Inquirer* and *The Philadelphia Daily News*, which had been purchased from their longtime publisher in 2006 for more than $562 million. The over $300 million in debt that had been incurred to make the acquisition soon proved to be more than the daily newspaper operations could bear in the Internet Age, and the company had sought bankruptcy protection in order to reorganize and restructure its debt. The process to market the dailies soon confirmed what many had predicted, that the enterprise value was nowhere near what the lenders were owed. The debtors proposed a Plan of Reorganization under which substantially all of their assets would be sold at public auction, with a group led by insiders serving as the stalking-horse bidder. If no higher and better bids emerged, the lenders would receive only $37 million in cash, real property valued at $29.5 million and subject to a two-year sweetheart lease.

The debtors sought approval of bidding procedures for an auction under a proposed Plan of Reorganization, which would not permit the lenders to credit bid their secured claim. Disagreeing with the Philadelphia bankruptcy court, which heard the case, and agreeing with the U.S. District Court that had reversed the bankruptcy court, the Third Circuit Court of Appeals held in a 2-1 decision that the bidding procedures were properly approved by the District Court, because lenders do not have an absolute right to credit bid whenever their collateral is being sold pursuant to a Plan of Reorganization. Furthermore, it held that the question of whether the lenders will receive the "indubitable equivalent" of their secured claims under the Plan (and not just from the auction itself) could be addressed when the bankruptcy court considers whether to confirm the Plan. The Circuit and District Courts noted that their rulings left open the door for the lenders to argue, at the Plan confirmation hearing, that the prohibition of credit bidding had failed to generate fair market value at the auction, thereby preventing them from receiving the indubitable equivalent of their claim. But the decision of the Circuit Court was clear: the hitherto assumed automatic right of secured lenders to credit bid their claims in a sale process created by a Plan of Reorganization was dead, at least in the circuit that includes Delaware.

From the perspective of lenders, these rulings spell real trouble, including the loss of influence or control over the sales process, reduced leverage in negotiations, and increased costs, delay and uncertainty of litigation over Plan confirmation. In cases within the Third and Fifth Circuits, lenders are likely to become entangled in litigation over valuation of their collateral, with debtors arguing for a lower valuation so that the lenders' secured claim can be cashed out at a lower price. Whether a Plan of Reorganization that provides for a sale of collateral without a right to credit bid meets the Bankruptcy Code's "fair and equitable" requirement for a cram down, and whether the denial of the right to credit bid precludes obtaining the fair market value for the collateral, will likely be contested whenever it potentially pays to do so. In courts outside the Third and Fifth Circuits, there is sure to be litigation over whether the rulings in *Pacific Lumber* and *Philadelphia Newspapers* should be followed. Judge Ambro's dissent in *Philadelphia Newspapers* was vigorous and persuasive, saying that the decision would have consequences for credit markets, and is likely to draw support from practitioners and academics alike.

Perhaps most important, the right to credit bid has given secured creditors the ability to make their own determination about the likely economic future of their collateral. For example, it is not uncommon for the value that third parties (or insiders) will offer to pay for a distressed business to be depressed by the company's recent history, industry conditions, as well as the bankruptcy process itself. However, a secured creditor might determine that, if it were to take its collateral, perhaps install new management and inject new capital, the enterprise value could well rebound and recover. So, the right to credit bid gives the secured creditor the option to pursue (and possibly finance) a turnaround plan that might result in a much better outcome, of course not without risk, rather than take the "hit" resulting from a sale price that is depressed because the company is in bankruptcy and presumably has been performing very poorly for some time. If the right to credit bid is reduced or eliminated, or even cast in doubt, lenders lose a possible advantage.

Clearly, the landscape for secured lenders has shifted considerably. While the pendulum has swung back in favor of borrowers, there are steps that lenders can take to deal with these changes, and to help mitigate their impact upon their economic interests. These will be covered in Part II of this article, which will appear in the next edition of *ABF Journal*.

PAUL A. RUBIN is a partner in the Restructuring and Bankruptcy Department of Herrick, Feinstein LLP, resident in its New York office. **HOWARD BROD BROWNSTEIN** is a certified turnaround professional and president of Brownstein Corporation, a turnaround management and distressed investment banking firm. He is a contributing editor of *ABF Journal*.

ENDNOTES:

1. The Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, Pub.L. 109-8, 119 Stat. 23.
2. *In re General Growth Properties, Inc., et al.*, 412 B.R. 122 (Bankr. S.D.N.Y. 2009)
3. *In re TOUSA, Inc. et al.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009)
4. *In re Yellowstone Mountain Club, LLC*, Bankr. No. 08-61570-11, Adv. Pro. No. 09-00014, 2009 WL 3094930 (Bankr. Mont. May 12, 2009)
5. *In re Pacific Lumber Co., et al.*, 584 F.3d 229 (5th Cir. 2009)
6. *In re Philadelphia Newspapers, LLC, et al.*, Nos. 09-4266, 09-4349, 2010 WL 1006647 (3d Cir. March 22, 2010)
7. Michael T. Rozea and Jeffrey A. Wurst, "The Not-So-Secured Right to Credit Bid," *ABF Journal*, Vol. 8, No. 3, April 2010, pp 56