



Bankruptcy / Finance ADVISORY ■

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ABI Commission Proposes Changes That Would Change Bankruptcy for Secured Creditors

Changes may be coming to the Bankruptcy Code that may affect secured creditors.¹ In 2012, the American Bankruptcy Institute established a Commission to Study the Reform of Chapter 11 (the "ABI Commission"). The ABI Commission is composed of many well-respected restructuring practitioners, including two of the original drafters of the Bankruptcy Code, whose advice holds great weight in the restructuring community. On December 8, 2014, after considerable discussion and analysis concerning potential reforms of the Bankruptcy Code, the ABI Commission issued its Final Report and Recommendation proposing amendments to the Bankruptcy Code. The Final Report contains extensive proposals that would impact secured lenders. Below is a summary of the most pertinent of such proposals.

Adequate Protection/DIP Financing/Prepetition Liens in General

- **Valuation of Collateral Based on New "Foreclosure Value"**

- The ABI Commission recommends that in determining the amount of adequate protection that a secured creditor should receive, courts should value the collateral based on a newly defined "foreclosure value."
- "Foreclosure value" is defined as the net value a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the collateral under applicable nonbankruptcy law, taking into consideration a secured creditor's ability to structure one or more sales, or otherwise exercise its rights, in a manner to maximize the value of the collateral. In the case of a foreclosure sale in which the secured creditor would acquire the collateral through a credit bid, the foreclosure value should be based on the net cash value a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale, and not on the face amount of the debt used to acquire the property through the credit bid.
- Of note, the Final Report confirmed that the foreclosure value would "not necessarily determine the value of such collateral or the secured creditor's allowed claim for other purposes in the Chapter 11 case," leaving open the possibility that postpetition changes in the collateral and/or different proposed uses of such collateral could result in a different value (something the ABI Commission terms the "reorganization value").
- In considering whether a debtor/trustee must provide adequate protection to a secured lender, the ABI Commission recommends that a court should be able to find a sufficient equity cushion exists if there is sufficient differential between the foreclosure value and the net cash value a secured creditor would realize in a hypothetical sale of the secured creditor's collateral under Section 363 (called the "value differential").

¹ This advisory represents Alston & Bird's second in a series of planned advisories discussing the ABI Commission's Final Report and Recommendation, its proposed amendments to the Bankruptcy Code and its impact on secured creditors and bankruptcy cases in general. On December 15, 2014, Alston and Bird issued its first advisory, "[ABI Commission Proposes Changes to Bankruptcy Code Safe Harbors](#)."

- **Relief from the Automatic Stay/Sale of Collateral**

- The ABI Commission agreed that a secured creditor should receive additional assurances if the court permits the debtor to provide adequate protection by showing a sufficient equity cushion in the property. Specifically, if the secured creditor, in these situations, subsequently obtains relief from the automatic stay or if the debtor's reorganization efforts fail, the secured creditor could elect to have the debtor in possession or the trustee sell the secured creditor's collateral under Section 363 of the Bankruptcy Code. This would provide secured creditors the means of realizing value through a court-approved process rather than through the use of state law remedies (such as foreclosure).

- **Limited Cross-Collateralization**

- It is not uncommon for secured lenders to request and obtain a provision that cross-collateralizes a secured creditor's prepetition debt with a lien on the debtor's or the estate's postpetition property. The ABI Commission proposes that this practice should be limited so these cross-collateralized liens would only be permitted to protect the secured creditors from any decrease in the value of the secured creditor's collateral as of the petition date.

- **No Liens on Avoidance Actions**

- The ABI Commission recommends that prepetition secured lenders should not be able to obtain adequate protection liens on the debtor's avoidance actions.
- The ABI Commission's proposal would not preclude secured lenders from obtaining a superpriority claim that attaches to such proceeds under Section 507(b) of the Bankruptcy Code.
- The ABI Commission recommends that debtor-in-possession (DIP) lenders be precluded from obtaining a lien or a superpriority claim in avoidance actions or proceeds.

- **No Acknowledgment/Confirmation of Liens**

- The ABI Commission recommends that debtors and trustees be precluded from confirming or otherwise acknowledging the validity and priority of liens securing prepetition obligations in any interim order.

- **Prohibition on Roll Ups**

- The ABI Commission recommends that courts not authorize the use of DIP loan proceeds to pay down, in whole or in part, prepetition secured claims unless: (1) the DIP facility is provided by new lenders that 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." If a roll-up is approved by the court, the ABI Commission recommends that such approval not be effective until the issuance of a final financing order.

- **Prohibition on Milestones and Benchmarks During First 60 Days**

- The ABI Commission recommends that courts not be authorized to approve, within 60 days of the bankruptcy filing, any order relating to a sale, entry of an order approving bid procedures or approval of a plan support agreement that includes "milestones, benchmarks, or similar provisions relating to a sale, entry of an order approving bid procedures, or approval of plan support agreement."

- **Prohibition on Waiver of Postpetition Surcharge of Collateral and Equities of the Case**

- Under Section 506(c), a debtor/trustee may recover certain costs from property securing an allowed secured claim to the extent such costs benefit the holder of such claim. Despite this provision, secured creditors often obtain a waiver of such right in connection with postpetition financing or adequate protection. In view of this common practice, the ABI Commission recommends revising the Bankruptcy Code to preclude trustees and debtors from waiving the ability to surcharge collateral, or to agree not to pursue such a surcharge, to the extent permitted under Section 506(c) of the Bankruptcy Code.
- The ABI Commission made a similar recommendation to Section 552(b) of the Bankruptcy Code and the "equities of the case" doctrine. Specifically, it recommends that a trustee or debtor not be allowed to waive the ability to assert that an actual expenditure incurred should be reimbursed to the estate to the extent such expenditures enhanced the value of collateral.

Intercreditor Agreements

- **Abridging Junior Creditors' Rights**

- The ABI Commission recommends that agreements between junior creditors and senior creditors waiving a junior creditor's ability to offer a non-priming DIP loan be rendered unenforceable; provided, however, the senior creditors should have the right to match the proposed terms. Similarly, any provision that would entitle the senior creditors to damages against the junior creditors for providing a non-priming DIP loan would be unenforceable.
- The ABI Commission also recommends that provisions waiving or assigning voting rights be unenforceable.

363 Sales

- **Ability to Sell Free and Clear**

- Under Section 363(f) of the Bankruptcy Code, a debtor/trustee may sell property free and clear of a lien only if: (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a monetary satisfaction of such interest. In analyzing Section 363(f), numerous courts disagreed on when otherwise applicable law permitted such a sale. To clarify a disagreement on whether a secured lender's foreclosure right was such an otherwise applicable nonbankruptcy law, the ABI Commission recommends modifying Section 363(f) to recognize that such foreclosure rights would not count.

- **Credit Bidding; No Limitation Based Solely on Chilling Effect of Credit Bid**

- Although Section 363(k) of the Bankruptcy Code preserves a secured creditor's right to credit bid at a sale of its collateral and use its debt to offset the purchase price, the right is not unlimited. Specifically, Section 363(k) allows the court to limit a secured creditor's credit bid for cause. In light of recent case law limiting the right to credit bid because such right could chill competitive bidding,² the ABI Commission recommends revising the Bankruptcy Code to provide that a mere chilling effect of a creditor bid should not be sufficient to limit a secured lender's credit bid right.

- **Auctions of Debtor's Assets Not Allowed During First 60 Days Absent Higher Showing**

- The ABI Commission recommends modifying the Bankruptcy Code to provide that neither auctions of, nor final approval of, a sale transaction involving all of the debtor's assets in the first 60 days shall be allowed unless clear and convincing evidence is shown that there is a high likelihood that the value of the debtor's assets will decrease significantly during that 60-day period and the court finds that the proposed sale satisfies the requirements for amended Section 363.

Court-Appointed Valuation Expert

- **Court Retention of Valuation Experts**

- In view of the fact that bankruptcy courts are being asked to hear and consider complex valuation disputes, the ABI Commission recommends that courts be permitted to retain a court-appointed expert and to rely on hearing testimony of the court-appointed expert in addition to any expert offered by the parties to assist in determining valuation issues.

Plan Confirmation

- **Cramdown Changes – *Till* Does Not Apply in Chapter 11**

- The ABI Commission recommends that the Supreme Court's holding in *Till v. SCS Credit Corp.*, 541 U.S. 465, (in which the applicable interest rate would be calculated by adding certain risk factors to the risk free rate) not apply in Chapter 11 cases. Instead, the ABI Commission recommends that the applicable interest rate for a cramdown be the market rate, and if no market rate is available, then

² *In re Fisker Auto Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014).

the court should apply an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as projections, leverage, revised capital structure and obligations under the plan.

- **Absolute Priority Rule – Preservation of Optional Redemption Value for Junior Creditors**

- Under the Bankruptcy Code’s absolute priority rule, secured creditors are entitled to receive payment in full prior to junior creditors and interest holders receiving any value. Nevertheless, in view of contentions that a plan may be confirmed or a sale approved during a downturn in the economy or during a particularly low point in the debtor’s operation, the ABI Commission recommends revising the Bankruptcy Code to provide the *immediately junior class* with “redemption option value.” Specifically, even if an impaired class of senior creditors would otherwise be entitled to 100 percent of the reorganization value of the firm based on its reorganization value on the effective date of the plan or Section 363 sale order, the ABI Commission’s recommendation would provide that the court should not confirm such a plan or sale unless the plan or sale provides for an allocation of “redemption option value” to the immediately junior class to the extent of its entitlement. This proposal is designed to modify the absolute priority rule to “incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or Section 363 sale order date, as the case may be, which would enable junior creditors to ‘redeem’ in full the allowed claim of the impaired senior creditors receiving the reorganization value of the company under such plan or sale.” However, such an option would not be owing if the junior class objects to confirmation. The ABI Commission also suggests that the redemption option value need not be an actual option, but could be satisfied through the payment of cash or the issuance of stock equal to the value of such option.

- The “redemption option value” is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period (the date that is three years after the petition date).
- The “redemption price” would be the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the nondefault contract rate and allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option as though the claims remained outstanding on the date of the exercise of the option.

- **Prohibition on “Class-Skipping”**

- In order to obtain consensual confirmation of a plan, debtors and lenders increasingly use payments to junior classes, notwithstanding their lack of an entitlement to receive any distribution, to incentivize the junior classes into accepting the plan. While these payments may be viewed as beneficial, these payments often skip one junior class to facilitate a distribution to a more-junior class and, thus, are challenged as being in violation of the absolute priority rule. The ABI Commission recommends amending the Bankruptcy Code to preclude class-skipping payments.

- **No Impaired Class Required to Confirm a Plan**

- Section 1129(a)(10) provides that “if a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan” must accept such plan. In view of perceived issues associated with artificial impairment and the gerrymandering of class, and the perception that such results in gamesmanship, the ABI Commission has recommended eliminating Section 1129(a)(10)’s impaired accepting class requirement.

- **Claim Voting and Tabulation**

- Although creditors that hold claims in different capacities and class would retain the right to vote on each claim individually, the ABI Commission recommends that if different claims—in one class—are held by affiliated entities, such claims should be aggregated and count as one vote.

These proposals to amend the Bankruptcy Code are likely to receive serious consideration from Congress and numerous pro-debtor and pro-creditor constituencies. Financial institutions and other financial market participants should continue to monitor—and weigh in on—these proposals in the coming months.

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