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Proposed Chapter 11 Reforms May Be Bad For Borrowers

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Late last year, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 released a report outlining its findings and recommendations. These proposed reforms have been touted by many as a triumph for debtors over secured lenders, which some people believe dictate the terms of modern bankruptcy cases for their exclusive benefit. If certain proposals are accepted and acted on by Congress, borrowers would be pushed into new territory that, in many ways, would be even less responsive to the needs of distressed businesses.

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While the commission acknowledges that certain recommendations could have an impact on pre-bankruptcy credit markets, the report does not engage in any meaningful analysis of this risk. This is of critical concern — as recent events have demonstrated that any regulatory change can have an outsized impact on short-term lending activity — and it is likely that the commission's proposals would trigger far more than a brief market correction.

The recent expansion of secured lending that the commission laments, particularly for less creditworthy borrowers, stems in large part from secured lenders' comfort in their ability to mitigate losses effectively in bankruptcy. By cutting secured lenders off at the knees in Chapter 11 cases, the commission's proposals could fundamentally change the way in which lenders underwrite deals and make it impossible for distressed borrowers to obtain financing at any price. Companies in need of a capital infusion in order to operate their business or bridge a short-term issue may not have a source of capital or, if they do, such capital could be offered on terms that are potentially disastrous to their business.

In addition to the general market risk shared by all borrowers, a number of the commission's proposals could put debtors in a far worse position even after filing for bankruptcy. The commission's attempts to empower other stakeholders in the Chapter 11 process will add greater complexity, delays and expense to a process that is already criticized for being too expensive. The reforms would also drive a wedge between debtors and secured lenders and neutralize a powerful ally in the fight to maximize value for all parties.

Adequate Protection

One of the commission's most controversial proposals relates to the calculation of adequate protection at the outset of a bankruptcy case. The commission recommends that the level of adequate protection required

to protect a secured creditor's interest be determined based on the "foreclosure value" of the secured creditor's collateral (or the amount a secured creditor would receive upon a "hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable non-bankruptcy law").

There is typically a substantial difference between foreclosure value and "going concern" or "reorganization" value or even "net orderly liquidation value." In tying adequate protection to foreclosure value, the commission proposes that courts look to this "value differential" as the initial source for adequate protection and only permit cross-collateralization to a debtor's post-petition property when, and solely to the extent, necessary to protect against the decrease in value of the secured creditor's collateral.

The commission attempts to mitigate the potential harm to secured creditors by recommending the use of the "foreclosure value" standard solely for the purpose of determining adequate protection and relying on "reorganization value" for purposes of distributions. This is arguably a false compromise. Without a sufficient cushion, a secured creditor will bear the entire risk of the deterioration in the value of its collateral during the pendency of a bankruptcy case, whether due to the funding of operating losses, priming liens or otherwise, which could make it impossible to realize the full "reorganization value" regardless of how their underlying claim is calculated.

The benefits to this approach from a debtor's perspective are clear. Freeing up property that would otherwise be needed to provide adequate protection would enable the debtor to use these assets to operate in bankruptcy or pledge them as collateral to obtain third-party post-petition financing. That being said, the commission ignores or downplays the many ways this approach could harm companies.

By refusing to protect secured lenders' right to anything more than the "foreclosure value" of its collateral at the outset of a bankruptcy case, these reforms would undermine the very foundation of secured cash flow lending, which has been a significant driver of economic activity in recent years. It would also impact the availability of asset-based financing as lenders tighten advance rates, change valuations upon which advances are made or impose additional reserves to mitigate this additional risk.

Increasing Options for Post-Petition Financing

The commission seeks to foster a more robust market for post-petition financing through its proposed reforms. Arguably, the biggest impediment to competition under the current system is debtors' general lack of unencumbered assets, which would be addressed by the proposed changes to adequate protection described above. The commission builds on this and suggests changes to post-petition financing terms aimed specifically at breaking secured creditors' perceived stranglehold over this process.

Most significantly, the commission weighs in on the current split among bankruptcy courts on the roll-up of prepetition debt into a post-petition facility. The report recommends a general prohibition on roll-ups unless the post-petition lender is not affiliated with the prepetition lender or extends substantial new credit on better terms than any alternative and, in either case, only if the court finds that the proposed post-petition financing is in the best interests of the estate.

While the report does not specifically address the issue of cross-collateralization in its recommendations, the background discussion and analysis makes it clear that post-petition assets would only be available to prepetition lenders in the context of adequate protection.

In its efforts to disadvantage preexisting lenders, increase competition and improve financing terms, the commission ignores the ways that differing motivations of third-party lenders could influence a Chapter 11

case. Debtors may be able to negotiate for a lower interest rate or more lenient milestones from a third-party lender but at the expense of introducing a new partner with broad powers to influence a bankruptcy case whose sole interest is protecting its limited interest in the estate.

The commission focuses exclusively on a debtor's lack of leverage in negotiating with its prepetition secured lenders while ignoring the fact that the opposite is also true. Prepetition secured lenders will often strike a better deal on post-petition financing than they otherwise would, or work with the debtor if things don't go as planned, in order to protect their broader interest in the survival of the company. Introducing a new lender also adds greater complexity to a bankruptcy case and threatens increased costs due to conflicts with the prepetition lending group.

The commission also advocates for a more direct expansion of the potential lender pool by invalidating contractual prohibitions on prepetition junior secured creditors offering or providing post-petition financing. The report recommends that these junior creditors be allowed to provide post-petition financing, even when they have agreed not to, so long as they do not prime the senior creditor and the senior creditor is given the ability to provide financing on the same terms.

The types of prohibitions that the commission references are one aspect of the multifaceted relationship between lenders reflected in an intercreditor. If such provisions are barred, well-settled intercreditor precedent would become unsettled and lenders would need to revisit all aspects of the intercreditor relationship in order to address the additional risk imposed by a junior creditor being able to drive its agenda by offering debtor-in-possession financing. Companies would, in turn, bear the expense of renegotiating these provisions and lose the benefit of years of established precedent in the market.

"Extraordinary Finance Provisions"

The commission's efforts to provide debtors with more options when seeking post-petition financing are motivated in part from a broader concern that the financing terms offered to debtors today make it more difficult, if not impossible, for these companies to reorganize. In particular, the report discusses provisions commonly found in post-petition credit agreements that seek to influence the course of a Chapter 11 case by requiring the debtor to abide by an agreed timeline to conduct an auction, close a sale, or file a disclosure statement and Chapter 11 plan. The commission also expresses concern regarding broad waivers that prevent a debtor from challenging the validity of prepetition liens and default or termination provisions tied to specific developments in a Chapter 11 case.

The commission recommends that courts refrain from approving otherwise permissible extraordinary financing provisions in interim orders to give other stakeholders time to review and weigh in on these proposed terms. The report also encourages the rejection of any post-petition financing that includes "milestones, benchmarks or similar provisions" of the type discussed within 60 days following the later of the petition date and the date of the order for relief.

In addition to the procedural delays described above, the commission also supports a general 60-day moratorium on conducting an auction or otherwise effecting a sale of substantially all of a debtor's assets. In order to shorten this timeline, a debtor or other party in interest would need to demonstrate by clear and convincing evidence that (1) there is a high likelihood that the value of the debtor's assets will decrease significantly during such 60-day period, and (2) the proposed sale satisfies the standards set forth in the principles for Section 363x sales.

It is difficult to know whether these recommendations would meaningfully reduce the number of expedited

sales out of Chapter 11, but the committee's proposals carry increased risks to debtors as well as secured creditors. Debtors who are clearly heading toward a 363 sale would be required to incur additional debt to continue to operate in bankruptcy while waiting for the court-imposed waiting period to conclude. Debtors would also bear the risk that further harm will come to their businesses during this period, resulting in a reduction to the ultimate purchase price.

Perhaps the greatest risk for debtors of a court-mandated waiting period is that it would discourage secured lenders from working on a restructuring outside of court. If prepetition secured lenders know there is a mandatory waiting period to conduct certain sales, they will tighten credit prior to bankruptcy and require companies to file bankruptcy potentially before an out-of-court restructuring can be effectuated. Secured lenders will be left with little choice as they will need to make certain that a debtor has sufficient liquidity to operate during the waiting period.

The "Redemption Option"

The most radical reform proposed in the report is a requirement that secured creditors provide certain out-of-the-money junior creditors or equity holders with what the commission refers to as the "redemption option value." This mechanism is intended to quantify (and transfer to out-of-the-money junior creditors or equity holders) the value of a hypothetical option to purchase the debtor, as a going concern, at a set time in the future.

Beyond the immediate harm suffered by secured creditors through erosion of recoveries, the "redemption option value" would introduce complexity to the bankruptcy process that vastly outweighs any potential benefit to out-of-the-money creditors. Conflicts over the calculation of the option itself and the amount of any cash or equity settlement would fuel litigation and the basic mechanic would be threatened constantly by new and more complex capital structures. This could choke off liquidity as secured lenders impose reserves to protect themselves from the risk of needing to share a portion of their recovery with more junior creditors. Additionally, as with many of the commission's other recommendations, this could negatively impact prepetition credit terms as well.

Conclusion

While a great deal of attention has been paid to the ways in which the commission's proposed reforms to the Chapter 11 process would harm secured lenders, it is critical to understand how this harm would be shared by all parties, including companies trying to restructure outside of bankruptcy and debtors after the case is filed.

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