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Our View: Commission's Proposed § 363 Sale Fix Not Bold Enough

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Editor's Note: *To learn more about the Commission's work and/or read its Final Report and Recommendations, visit commission.abi.org.*

The ABI Commission to Study the Reform of Chapter 11 released its Final Report and Recommendations in December 2014. As the Report notes, the three-year project involved hundreds of top professionals representing diverse stakeholders and yielded a 400-page report with more than 200 discrete recommendations to modernize the law of business bankruptcy.[1] While this process produced a report to be utilized by Congress in its deliberations, and ultimately by the courts, there are, of course, a range of other policy options.

This article responds to the Report, both from an economic and legal policy prospective, and examines whether its proposed changes to the Bankruptcy Code would fix the problem identified by the Report — *i.e.*, the difficulty in obtaining debtor-in-possession (DIP) financing to continue operations, resulting in increasing pressure to monetize the debtor's assets through a quick § 363 sale to the detriment of junior creditors. While the Commission addresses these issues, the Commission itself acknowledges that the Report is one of consensus (albeit, following spirited debate and advocacy) and perhaps constitutes a reflection of what is achievable in the political process. Nonetheless, in our view, the Commission has not gone far enough in reforming the § 363 sale process. The process and timing for determining competing creditor rights needs to be balanced with the need for the debtor to sell its assets, a secured creditor's right to protect and/or realize the value of its collateral, and the rights of creditors — both general and administrative — to ensure a fair process in determining the value allocated to different creditor classes.

Under economic theory, optimal bankruptcy law would (1) quickly and efficiently identify debtors that can maximize value for creditors through reorganization as opposed to liquidation, (2) create a process that will likely realize maximum recovery for creditors, and (3) create a process that would efficiently distribute the debtor's assets to creditors according to the absolute priority rule. The Commission attempts to achieve this result, but it focuses on the second prong, which proposes to determine the reorganization value (and attach it as an appendage to a purchase price), and provides incomplete solutions to the first and third prongs. By focusing mostly on this second prong and utilizing the process/remedy, the Commission has proposed an imperfect cure that may well kill the patient.

The Commission Has Not Fixed the "Loan to Own" Problem

As the Commission co-chairs have noted, many — if not most — chapter 11 cases today are dominated by secured lenders or secured noteholders, unlike when the Bankruptcy Code was enacted in 1978.[2] These secured creditors' groups often seek to effectively foreclose on their security interests and receive a federally approved order selling the debtor's assets free and clear with releases at the very outset of the chapter 11 case, while junior creditors are economically disadvantaged from providing meaningful input. As a result, the system lacks transparency. In many cases, chapter 11 has morphed from a framework within which to implement a debtor's reorganization plan into a national foreclosure act.[3] Following the sale of substantially all of its assets, a debtor's estate is usually left with, at best, a liquidating chapter 11 plan — but often a dismissal or conversion to a case under chapter 7.

Chapter 11 was not intended to be a safe haven for secured lenders to avoid state foreclosure laws.[4] Rather, its intent was to reorganize a debtor through the implementation of a reorganization plan. Yet the Commission proposes that the Bankruptcy Code should be amended to (1) set a higher judicial standard for an immediate § 363 sale and a *quasi*-fair and equitable valuation test that potentially appends an option tail to the purchase price, and (2) provide a moratorium on all § 363 sales until 60 days after the petition date. In response to the proposed "60-day rule," we note that 60 days is an arbitrary cut-off. In cases that we have participated in (or have reviewed), 90 days can be considered a quick sale — particularly in

1 Significantly — and in a departure from past law reform efforts — the Commission pursued a consensus approach to reform, making recommendations that were only supported by all 22 voting Commission members.

2 Robert J. Keach and Albert Togut, "Commission to Explore Overhauling Chapter 11," XXX *ABI Journal* 5, 36-37, 83, June 2011, *available at* abi.org/abi-journal.

3 Commission Final Report at 229.

4 The Third Circuit's recent decision in *In re Jevic Holding Corp.*, 2015 U.S. App. LEXIS 8380 (3d Cir. May 21, 2015), seemed to uphold structured dismissals, subject to the facts of each case. The Third Circuit held that courts can approve settlements that contravene the Bankruptcy Code's priority scheme when there are "specific and credible grounds to justify the deviation." *Id.* at *26.

a complex case where a debtor and certain inside creditors have extensively planned and plotted their preferred course for the bankruptcy case pre-petition. The Report proposes that this 60-day rule could be waived pursuant to a court order in the event of "extraordinary ... circumstances, which must be established by clear and convincing evidence at the hearing on the motion requesting an expedited sale process,"[5] ultimately leaving the proposed 60-day rule to always be subject to judicial interpretation by individual bankruptcy courts and leaving open the possibility that the exception could become the rule.[6]

While the Commission heard testimony on the pervasive "loan-to-own" scenario wherein a distressed investor purchases a loan from a traditional lender expecting the company to fail so that the investor can take control of the company, it does not address the problem. Furthermore, valuation fights can be speculative, and other § 1129-type protection requirements proposed in the Report do not ensure an active and robust auction and sale process that could maximize recovery to creditors. Such a process is critical in the § 363 sale context. Valuation fights can last many weeks, and in at least in one case, we note that it turned out to be inconclusive.[7] Given the length and breadth of a valuation fight, the patient may die while on the operating table.

The Commission's proposed remedies do not go far enough to properly internalize the external economic cost to the estate of a chapter 11 proceeding on junior and administrative creditors where the sale is being conducted solely for the benefit of secured lenders. Administrative creditors run the risk of nonpayment, and general unsecured creditors (whose provision of goods and services may have kept the secured lender's collateral afloat) risk total loss. In some jurisdictions, bankruptcy courts have stepped up to the plate and forced secured creditors to internalize the external costs of the chapter 11 proceeding commenced for their benefit by requiring, as part of the auction and sale process, that sufficient proceeds are left aside from the sale to pay administrative creditors, including § 503(b)(9) creditors. For example, one court curtailed a secured lender's credit bidding rights,[8] but a judge-made law does not go far enough and is not uniform across jurisdictions. Furthermore, while the Commission does recommend that § 506(c) (so-called surcharges on secured creditors' collateral) not be waivable, it does not grant § 506(c) rights to any party other than the "Trustee," thus leaving creditors that seek payment from the secured lenders left holding the bag, and subject to the debtor's largesse.[9] In order to properly internalize the externalities of the chapter 11 case benefiting solely a secured creditor and to level the playing field for junior creditors, we suggest the following procedural and administrative amendments to the Bankruptcy Code.

Alternatives to the Commission's Proposed § 363 Amendments

First, a secured lender that seeks court approval of a § 363 sale of substantially all of the debtors' assets at the outset of a chapter 11 case must declare/elect its intention to credit bid its lien/claim at the outset of the § 363 sale process. In the event that the declaration is not made, the secured creditor forgoes its right to credit bid. This election would be similar to a § 1111(b) election, wherein an undersecured creditor can elect to either (1) have an unsecured deficiency claim under § 506(a), or (2) waive its deficiency claim and have the total allowed amount of its claim treated as though it were fully secured by the collateral. Here, a secured lender would be required, at the outset of the § 363 sale process, to elect whether it intends to credit bid. This avoids any last-minute chilling effects such a credit bid may have at an auction. In the event of a sale that takes place under a § 1129 reorganization plan, a secured creditor does not need to declare its intention to credit bid until such time as the auction process takes place and is not subject to the requirement set forth in (2) above, but the secured creditor would nevertheless be required to comply with all other requirements of § 1129 (*i.e.*, all administrative claims must be paid upon the effective date of the reorganization plan).

Second, § 506(c) should be amended to provide that a secured lender that seeks court approval of a § 363 sale of substantially all of the debtors' assets at the outset of the chapter 11 case must pay the reasonable attorneys' fees and costs of maintaining the debtors' estate and any appointed creditors' committees and their professionals through the closing of a sale (*i.e.*, the so-called "burial costs"). This requirement would, however, be avoided if such secured lender declares at the outset of the § 363 sale process that it will not credit bid its lien/claim.[10]

Third, § 506(c) should be amended to allow any party in interest in the bankruptcy case that can demonstrate preservation of the secured lenders' collateral resulting from an immediate § 363 sale to make a claim on the proceeds of collateral.[11] As the Commission noted, § 506(c) rights should be unwaivable — whether by the debtor or the bankruptcy court — with respect to the proceeds of such § 363 sale. In the event of an immediate § 363 sale, § 506(c) should also provide for the payment of § 503(b)(9) claims for goods delivered within 20 days prior to the petition date, as well as all ordinary-course unsecured trade creditors' claims (including claims for services) and landlord claims for a 20-day period prior to the petition date.

Economic Theory of Externalities

These proposed changes are intended to ensure that secured lenders, who are essentially seeking to use the Bankruptcy Code as a means of foreclosure, internalize the externalities that are typically passed onto other parties-in-

5 Commission Final Report at 87.

6 One would be hard pressed to find a court that did not find some form of a "melting ice cube" situation, even in a loan-to-own scenario. The Commission does not posit whether, for example, a DIP lender's refusal to lend or a buyer's refusal to buy unless a sale is made within 60 days of the petition date qualifies as an extraordinary circumstance.

7 *See In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Tex. 2005). *See also* Commission Report at 201, 207.

8 *In re Fisker Auto. Holdings Inc.*, Case No. 13-13087 [ECF No. 435].

9 Commission Final Report at 229. Similarly, the Report makes the trustees' rights to claim equity of the case for entitlement to a claim the enhanced value of the estate *vis-à-vis* the secured lender's claim nonwaivable.

10 However, it would apply in circumstances where the lender directs the debtor to sell to a specific buyer, thus circumventing the rule.

11 *See Hartford Underwriters Ins. Co. v. Union Planters Bank NA*, 530 U.S. 1, 8, 12 (2000) ("[W]e believe by far that the most natural reading of § 506(c) is that it extends only to the trustee" and that "a better policy outcome ... is a task for Congress, not the courts.").

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interest. These proposed provisions also level the playing field, enabling junior creditors (through an official committee or otherwise) to garner the resources and time that would be necessary to seek out a possible bidder (or overbid) for the assets to realize greater value and increase their possible recovery. Moreover, these proposed changes can only add transparency to the process.

The concept of internalizing externalities is not new. "Externalities" occur when impacts are generated by one economic actor affecting others, but the market does not, on its own, require that the actor generating such impacts compensate other affected actors.[12]

In chapter 11 cases, secured creditors — particularly those that also act as a DIP lender and that are secured by substantially all of the debtor's assets (or a debtor's critical asset) — wield their economic power in several ways. Initially, they have the power to force an immediate sale of the debtor's assets. Further, by granting limited access to cash collateral and DIP financing, they control the debtor's ability to operate in chapter 11. They also often wield *de facto* control over the bankruptcy courts by giving bankruptcy judges the Hobson's choice between a complete collapse of both the bankruptcy case and the company vs. the possibility of a higher offer that might materialize to maximize value to junior creditors through an auction and sale process. A secured lender that is also an asset-purchaser can (1) use its credit bidding powers to chill bidding, (2) often pick and choose what pre-petition contracts and liabilities/claims it wishes to assume, and (3) dictate the timing of a sale. Faced with these choices, some courts have squared off against secured lenders and exacted various remedies, such as insisting that administrative creditors be paid — including § 503(b)(9) creditors.

For example, in *In re Townsends Inc.*,[13] the bankruptcy court would not approve the debtor's proposed DIP financing because the proposed order did not provide reasonable certainty that § 503(b)(9) administrative claims would be paid. On the other hand, in *In re Allen Family Foods Inc.*,[14] a court (in the same district) approved a quick sale of assets that primarily benefited the debtors' secured creditors and did not assure payment to § 503(b)(9) creditors.

Another bankruptcy court also ruled that a secured creditor with a partially disputed claim would only be allowed to credit bid its secured claim in an amount equal to the purchase price that it had paid for the claim.[15] Relatively recent cases in the District of Delaware and Southern District of New York exemplify how secured creditors have used chapter 11 as a foreclosure act, often to the detriment of other creditors.

In *In re RadioShack Corp.*,[16] Standard General became RadioShack's largest shareholder and one of its largest creditors less than six months prior to its chapter 11 filing (when RadioShack's financial *extremis* was well known) when it provided $120 million in rescue financing in exchange for control of the board of directors. Far from being a "melting ice cube," creditors argued that RadioShack's bankruptcy was timed so that various debt-holders could benefit from their credit-default swap positions. After a hotly contested fast-track sale hearing wherein secured lenders credit bid rights were challenged and accusations of a sham auction were raised (along with concerns of administrative insolvency), the court approved Standard General's bid, including the credit bid component, allowing it to credit bid its lien and acquire RadioShack's assets.

In *In re ProNerve Holdings, LLC*,[17] the debtor also filed a § 363 sale motion on the first day. The stalking-horse bidder, prior to the petition date, acquired all of the debt under the debtors' secured loan commitments (presumably at a discount) and intended to credit bid its newly acquired secured debt. The court approved the sale despite claims that the proposed bidding procedures were fundamentally unfair to creditors, as they walled off other prospective bidders and inappropriately favored the stalking-horse bidder.

In *In re TeeVee Toons Inc.*,[18] the debtors sought to sell substantially all of their assets to the secured pre-petition/DIP lender, which credit bid its liens to acquire the debtors' assets. The creditors' committee's attempt to limit the credit bid was unsuccessful, and the case was converted to chapter 7 approximately four months after the sale order was signed and the estate was administratively insolvent. In *In re Patriot Coal Corp.*[19] and *In re Colt Holding Co. LLC*,[20] the debtors also commenced § 363 sale processes on the first day of the case.

Economic Analysis

Our proposal to reform § 363 would address the problems that these cases pose and is also economically sound. Consider the following hypothetical example of a typical bankruptcy case. In such a typical case, the debtor will have the following structure of claims and assets:

Claims:

A = Administrative claims to be determined as the case proceeds
S = Secured claims
U = Unsecured claims

Assets:

C = Assets pledged to secure the claims of the secured creditors
R = Assets not specifically pledged

The value of the debtor's assets in the bankruptcy proceeding can be viewed as one of two amounts determined as follows:

12 Neva Goodwin, "Internalizing Externalities: Making Markets and Societies Work Better," 52 *OpinionSur* 1, 1-2 (December 2007).
13 No. 10-14902 (Bankr. D. Del.).
14 No. 11-11764 (Bankr. D. Del.).
15 *Fisker*, *supra* n.5.
16 No. 15-10197 (Bankr. D. Del.).
17 No. 15-10373 (Bankr. D. Del.).
18 No. 08-10562 (Bankr. S.D.N.Y).
19 No. 15-32450 (Bankr. E.D. Va.).
20 No. 15-11296 (Bankr. D. Del.).

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Q = The value to be derived from a quick sale of the secured collateral
M = The value of the secured assets if the sale is conducted so as to achieve maximum value.
R = The value of any residual assets not pledged as collateral.

Using this structure, we see that the amount of the total creditor claims in the estate is equal to $TC = S+A+U$. Similarly, the total value of the estate will equal either $TAQ = Q+R$ or $TAM = M+R$. The value not obtained in a quick sale is equal to $L = M–Q$.

Conclusion

As our economic and case law/analysis indicates, secured lenders have an incentive to seek such a result whenever Q is greater than S. Secured creditors have an incentive to seek a quick sale whenever the proceeds will achieve a full recovery for the secured claimants, regardless of its impact on the other claimants. In some instances, even the administrative claims will not be covered by what is left in the estate once the secured assets are sold.

In all cases where M is substantially greater than Q, the impact of a secured lender-controlled case is to sacrifice the interests of the unsecured claimants in order to facilitate a quick recovery for the secured creditors. We propose legislative amendments that more directly incentivize secured lenders to internalize such externalities (such as the so-called burial costs) and do so in a way that allocates economic resources more fairly and efficiently. abi