A new chapter

An influential insolvency reform commission has recommended major changes in the treatment of lenders under the US Bankruptcy Code. **Stephen D Lerner** and **J Maxwell Tucker**, of Squire Patton Boggs (US) LLP, outline the most significant proposals and their potential effects

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Chapter 11 of the US Bankruptcy Code, with its goal of encouraging the reorganising of debtors as going concerns, has been the envy of many nations where insolvency schemes generally offer few choices outside liquidation. However, the code has not had a major overhaul since 1978. In recent years a concern has arisen that too many companies have been rushed through Chapter 11 process simply to be sold or liquidated.

After two years of study, a commission appointed by the American Bankruptcy Institute recently proposed hundreds of recommendations on refurbishing the code. Their report – which runs to more than 400 pages – addresses a wide variety of topics, from modifying the rights of secured lenders in large corporate workouts to creating a viable restructuring path for small businesses. Several proposed reforms, if enacted into law, would significantly impact the rights of lenders.

Bipartisan lawmakers in both the House and Senate are currently evaluating the recommendations of the commission. The chairmen of the bicameral judiciary committees will engage stakeholders and convene hearings on the recommendations. After an appropriate degree of vetting and adequate policy debate, Congress may take up legislation to update Chapter 11 among other bankruptcy provisions.

Changes to adequate protection of secured creditors

A Chapter 11 filing stays creditor remedial actions including foreclosures. However, a debtor may continue to use its property to operate its business which may diminish the value of a secured creditor's collateral. The concept of adequate protection is intended to compensate for the inability of the secured creditor to access its collateral and any resulting loss in value. How to determine the amount of loss is up to the courts, which have used a variety of valuation standards including liquidation value and going concern value.

The commission proposes that for purposes of determining adequate protection, a secured creditor's interest should be determined based on foreclosure value – meaning the value that a secured creditor's non-bankruptcy foreclosure efforts would produce if the bankruptcy had not been filed.

Furthermore, the commission proposes the court should be able to consider evidence that the net cash value that a secured creditor would realise upon a hypothetical sale of collateral under section 363 exceeds the collateral's foreclosure value – a value differential. If the court finds that a value differential exists, the commission proposes that the bankruptcy court may premise adequate protection solely upon such value differential, thus without the need for interim payments.

Formalising the new value exception to the absolute priority rule

The absolute priority rule requires that senior classes of claims be paid in full prior to junior classes receiving any distributions under a Chapter 11 plan. Consequently, equityholders generally cannot retain or receive new equity in the reorganised company unless all creditors are either paid in full or all creditor classes accept the plan.

However, frequently equityholders may be the most viable source of funding in bankruptcy and may include individuals whose continued association with the business is critical to future success. Many argue that the policy favoring business reorganisation over liquidation can be best implemented by allowing the owners to buy back in the reorganised business. The buy back in concept has been implemented by a judicial construct called the new value exception, which has never been held valid by the Supreme Court.

The commission proposes that a statutory new value exception be enacted. Under the proposal, a new value Chapter 11 plan which fails to garner support from its unsecured creditors may nonetheless be approved as long as the new value is (i) in the form of new money or money's worth; (ii) in an amount proportionate to the equity received or retained by prepetition equityholders; and (iii) subjected to a reasonable market value test. The commission declined to define an appropriate market test in favour of courts making this determination based on the facts and circumstances presented.

The absolute priority rule is a long-standing principle upon which lenders have relied to extend credit. If the new value exception were enacted, dissenting creditors would lose the ability to vote to block plans, and would face potentially expensive litigation over the sufficiency of the new value offered.

Chapter 11 plan valuation

Valuation of a secured creditor's collateral may be different depending upon the stage of a Chapter 11 case. As noted above, for purposes of adequate protection, foreclosure value is used. The commission has recommended reorganisation value for purposes of a Chapter 11 plan. Determining reorganisation value depends on whether the debtor will be reorganised or sold. If reorganised, it means the enterprise value of the debtor. If sold, reorganisation value means the net sale price received by the estate. Utilising the concepts of foreclosure value and reorganisation value, the commission sought to balance the interests of debtors to use their property to effect a reorganisation with the right of secured creditors to ultimately obtain the going concern value of their collateral.

> "Altering senior lender rights carries implications for the cost of credit"

Proposed reform of cram-down interest rates

The code currently allows a Chapter 11 plan to cram down a secured creditor that has refused to approve the plan. The plan must permit the secured creditor to retain its lien and offer the secured creditor deferred cash payments having a present value equal to the value of the collateral. However, a controversy exists regarding the appropriate discount rate – the cram-down interest rate – for calculating the present value of the deferred cash payments.

Various approaches have been utilised by courts to determine an appropriate rate, but there is no uniformity in Chapter 11. In 2004 the US Supreme Court approved use of the formula approach for purposes of a consumer debtor's Chapter 13 plan. This approach requires a court to use the risk-free rate of interest at the time of the determination, adjusted by 100 to 300 basis points to account for the risk of default in the given case, the nature and quality of the collateral and the duration and feasibility of the plan.

While the court limited its holding in Till to Chapter 13 consumer cases, many lower courts later concluded that the reasoning applied with equal force to Chapter 11 business cases. Other courts and commentators criticised the use of a formula approach in Chapter 11 cases.

The commission recommends rejecting the Till standard for Chapter 11 cases and using the cost of capital for similar debt issued to companies comparable to the debtor as a reorganised entity. If such market rate cannot be determined for a particular debtor, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed to the lender by the reorganised debtor's retention of the collateral considering factors such as the debtor's industry, projections, leverage, capital structure and obligations under the plan.

Protecting junior creditors with a redemptive option value

One controversial recommendation attempts to remedy the perception that secured lenders have bullied their defaulting borrower into promptly selling assets under Section 363. Because these sales may occur at a low ebb in cyclical markets which may not reflect fair value, second-lien and other junior creditors have argued they are penalised merely for bad timing.

To level the playing field, the commission proposes swinging more value toward subordinated groups by allowing junior creditors to receive potential upside by means of a new right to receive redemption option value. If the proposal were enacted, the creditor class immediately junior to the class that has received the final residual value – i.e. the last group receiving a recovery under traditional priority rules – in a sale or Chapter 11 plan would receive value equal to the price of a three-year option with a strike price equal to the payoff amount for the entire senior debt plus interest at the non-default contract rate for the full three years.

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The policy choice that junior creditors receive an upside entitlement is controversial. This ROV safe harbour may avoid difficult and expensive valuation controversies between senior and junior creditors, but altering senior lender rights carries implications for the cost of credit, and subsequent subordination agreement pricing may need to be adjusted.

Congressional reaction

Legislative committee staff received pre-release briefings on the commission's voluminous recommendations. However, the commission's timing coincided with the rush to complete must-pass legislation at the end of the 113th Congress and the Hill is just beginning to contend with the policy implications. With Republicans gaining Senate control, the likelihood of Congress passing bankruptcy reform increases. That said, there remain many hurdles to passage.

Conclusion

The commission hopes its report will lead to spirited debate on the issues. Change is clearly in the wind. While it may take years for these and the commission's myriad other recommendations to be debated, it is clear that Congress thinks the time for Chapter 11 reform is ripe, and we expect greater stakeholder engagement in 2015. Prudent senior secured creditors, banks, small businesses, and business enterprises should visit with the House and Senate judiciary committees and the House financial services committee to ensure that their interests are protected in any new legislation.

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