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SECURED TRANSACTIONS

A New Chapter 11 Could Impair Creditor Rights

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The current version of the U.S. Bankruptcy Code (the code),[1] which has been in effect since 1978, has been the only federal bankruptcy law that most secured transactions and workout professionals now in practice have ever needed to know. That may change in the not-too-distant future, however, if the American Bankruptcy Institute (ABI) has anything to say about it. The ABI has commenced an initiative, the goal of which is a modernization of the reorganization provisions of Chapter 11 of the code. This project may dramatically affect many of the rights and remedies on which secured creditors now rely in bankruptcy.

Background

The U.S. Constitution expressly gives Congress the power to enact "uniform laws on the subject of Bankruptcies" throughout the United States.[2] During the first century of the nation's existence, Congress exercised this authority in fits and starts, passing bankruptcy legislation in 1800, 1841 and 1867 and, in each instance, repealing the legislation shortly after enactment. The first federal statute intended to deal comprehensively with bankruptcy was the Bankruptcy Act of 1898, but, like its predecessors, even the 1898 Act lacked corporate reorganization provisions.

Nevertheless, the enormous growth of corporations and business trusts in the late 19th century generally, and the financial difficulties that railroads experienced in particular, showed that a procedure to rehabilitate distressed businesses under judicial protection was required. Courts sought to meet that need by using the common law to develop a system of equity receiverships that constituted the beginning of modern reorganization law.

Forty years later, the next expansive legislation, the Bankruptcy Act of 1938, was the first to codify corporate reorganization provisions. Indeed, the 1938 Act devoted not one but *three* separate chapters to the concept of reorganizing businesses—Chapter X, intended for the reorganization of large corporations; Chapter XI, intended for the relief of small debtors, whether or not incorporated; and Chapter XII, providing for real property arrangements by persons other than corporations.[3] When the code replaced the 1938 Act in 1978, it merged the reorganization provisions of these three chapters into a new Chapter 11 to provide a unified system for rehabilitating and reorganizing distressed businesses, large or small, public or private, in an effective and efficient manner. The code also adopted the concept of the debtor-in-possession (DIP), instituted procedures for DIP financing and use of cash collateral, prioritized and protected secured and unsecured creditors' rights, and established countless other provisions and procedures familiar to today's practitioners.

Nevertheless, the economic and commercial landscape has changed enormously since the code went into effect nearly 35 years ago. Among other things:

When the code replaced the 1938 Act in 1978, it merged the reorganization provisions of three chapters into a new Chapter 11 to provide a unified system for rehabilitating and reorganizing distressed businesses, large or small, public or private, in an effective and efficient manner.

• Secured credit has grown considerably as a method of financing ordinary-course business operations and expansions, with prepetition lenders often taking "all asset" liens. Thus, if a borrower subsequently needs to enter Chapter 11, it has few, if any, unencumbered assets available to serve as collateral for postpetition DIP financing. Accordingly, most DIP financing is now provided only by prepetition secured lenders.

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• It is usually the case that the prepetition secured credit lines are fully advanced at the time a business enters Chapter 11, and since the lenders desire to preserve collateral value, they typically make very little liquidity available to the debtor under the DIP facility. Thus debtors today frequently have little working capital with which to finance their operations in bankruptcy. Consequently, especially since the credit crunch of 2008, lenders have required stricter covenant protections as a condition to providing DIP financing. In particular, businesses that enter bankruptcy now often have to agree with their secured lenders to sell themselves or their assets, or to file a plan of reorganization or liquidation, almost immediately upon filing. That way the lenders mitigate the risk that the debtor will remain in Chapter 11 for an extended period without adequate working capital.[4]

• U.S.-based manufacturing has declined precipitously, replaced by a high-tech and service economy in which business assets tend to be intangible and hard to monetize in bankruptcy rather than consisting of more easily-marketed inventory, equipment, realty and other tangible property.

• Commerce and finance have gone global, and many businesses and financial institutions now have an interconnected worldwide footprint.

• Many sophisticated financial instruments and products (e.g., securitizations, swaps and other derivatives) that did not exist in 1978 have been developed and can have a huge bearing on a reorganization.

• Hedge funds and other investors interested in profiting from bankruptcy claims have become significant players in the reorganization world, and an enormous secondary market in trading loans and bankruptcy claims has developed. This often results in fluid constituencies that affect negotiation dynamics and can turn bankruptcy courts into arenas for takeover contests.

• The code itself has become a political battlefield on which competing creditor constituencies exercise influence. It has been amended numerous times, most recently in 2005,[5] in ways that prefer certain parties in interest at the expense of others and that, cumulatively, have made Chapter 11 an increasingly inhospitable place for debtors.

Various bankruptcy professionals—attorneys, financial advisors, turnaround managers and others—who predominantly advise debtors have cited these changes and other developments as evidence that the code no longer facilitates the rehabilitation of businesses and needs to be modernized again so it can serve its intended function. The ABI initiative is designed to do just that.

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The ABI Commission

According to its website, the ABI is "the largest multi-disciplinary, nonpartisan organization dedicated to research and education on matters related to insolvency" and was founded in 1982 "to provide Congress and the public with unbiased analysis of bankruptcy issues." It claims a membership of more than 13,000 attorneys, auctioneers, bankers, judges, lenders, professors, turnaround specialists, accountants and other bankruptcy professionals.[6] Last year, it constituted a 22-member "Commission to Study the Reform of Chapter 11."

The commission's stated purpose is to study and propose reforms to Chapter 11 and related statutory provisions that "will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders."[7] The commission has formed committees to study 13 discrete topics.[8] It has conducted several "field hearings" at which various prominent senators, judges, bankruptcy attorneys, academics, bankers and other professionals have given oral and written testimony,[9] and seven more hearings are scheduled to be conducted by the end of 2013. The commission aims to issue next year a consensus report and recommendations that will prompt Congress to adopt conforming legislation in time to continue the 40-year cycle in which, like clockwork, federal reorganization law historically has been overhauled comprehensively.

Is Secured Credit Being Targeted?

As is evident from the scope of the study topics, the commission is dealing with a wide range of business reorganization issues that affect the secured creditor community only indirectly. For instance, one of the issues under evaluation is whether the reorganization of small and medium-sized businesses should be conducted under a framework separate from that applicable to large businesses, as was the case under Chapters X and XI of the 1938 Act.

Nevertheless, the effect of secured credit (both prepetition and postpetition) upon the reorganization process and the activities of loan market participants (both loan originators and secondary market buyers and sellers, including hedge funds) clearly are matters that the commission believes are areas needing reform. The commission's purpose statement declares that revision is required because of "the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code." A number of commission members and other witnesses have testified in favor of curbing long-standing rights of secured creditors that heretofore have been validated under the code. It has been suggested, for instance, that:

• The U.S. Supreme Court's recent decision in *RadLAX Gateway Hotel v. Amalgamated Bank*,[10] which confirmed that secured creditors have the right under the code to credit-bid, should be overturned and that credit-bidding should be restricted;

• The provisions relating to sales under §363 of the code should be revised so as to "tax" or surcharge secured creditors for the benefit of the estate when their collateral is sold;

• Prepetition liens should exclude (or "carve-out") some percentage of every dollar of realizable value for unsecured creditors;

• The pre-eminent status that secured creditors have under the code's "absolute priority" rule should be revisited in an effort to provide unsecured creditors with greater relief;

• In cases where collateral is sold, the secured creditors should not be permitted to recover from the sale proceeds more than the liquidation value of the collateral. If the sale generates "enterprise values" (as might occur in connection with the sale of the entire business, or a whole business line, of the debtor as an operating entity), this "going-concern surplus" would instead be available to the estate even if the liquidation value limitation leaves the secured creditors with a deficiency;

• DIP lenders should be prohibited from receiving all of the covenant protections that have become common in recent years (such as the debtor's undertaking either to quickly sell itself or its assets, or to promptly file a plan of reorganization or liquidation);

• The "roll-up" of prepetition debt into the postpetition DIP financing, which is now common, should be reexamined; and

• The allowed amount of a secured claim purchased in the secondary market should be limited to the purchase price of the claim rather than its face amount.

The concern with which some commission members and witnesses view secured credit is illustrated by commissioner and law professor Kenneth Klee. He testified, in effect, that federal bankruptcy law should upend the statutory secured transactions scheme set forth in article 9 of the Uniform Commercial Code, saying: "Just because commercial lawyers have crafted non-bankruptcy laws to favor secured creditors and to encourage securitization transactions does not mean that a business reorganization law should respect those laws inviolate." He also stated that other systems "facilitate the sale of secured creditors' collateral during bankruptcy free and clear of liens, and we should carefully consider the wisdom of adopting a similar approach," thus suggesting that prepetition liens be made vulnerable to being stripped routinely in bankruptcy.[11]

The cochairs of the commission have denied that the commission is prejudiced against secured lending.[12] Not surprisingly, given the commission's purpose statement and the revisions that numerous commissioners and witnesses have suggested, however, many secured creditors remain skeptical. They are concerned that the ABI initiative is intended principally to restrict their rights significantly.[13] Accordingly, several industry groups whose members regularly originate or acquire secured debt, such as the Loan Syndications and Trading Association, the Commercial Finance Association and the Managed Funds Association, are mobilizing to protect against the erosion of the rights and remedies that secured parties and loan market participants currently enjoy in bankruptcy. These organizations are capable advocates; they are articulating forcefully that secured credit is important for the economy and that restricting the bankruptcy rights of secured parties will make credit costlier and harder to obtain, especially for smaller or financially-troubled enterprises.[14]

Conclusion

It is too early to predict exactly what bankruptcy law revisions the commission will recommend, much less whether and to what extent Congress will adopt them. One need not be Sherlock Holmes, however, to see that the game is afoot. The commission doubtless will be making proposals to modify the code in ways that will affect liens and the holders of secured claims significantly. Secured transactions practitioners will want to stay abreast of these developments.

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1. 11 U.S.C. §§101, et seq.
2. U.S. Const. art. I, §8, cl. 4.
3. Chapters X and XI of the 1938 Act did not always coordinate well, as contemporary scholars noted shortly after that act went into effect:

> In its large way, Congress intended Chapter X for the reorganization of big corporations, and Chapter XI for the relief of small debtors, incorporated and unincorporated. But the forty-odd experts who worked eight years revising the act omitted from it any formula for determining which corporate debtors should be rehabilitated under Chapter X and which under Chapter XI. As things stand, Chapter X and Chapter XI offer alternative systems for the reorganization of corporations generally, and it is established practice for similar corporations, in comparable financial difficulties, to be reorganized under either chapter. Yet the two reorganization chapters are violently inconsistent. They provide incompatible procedures and they appear to contemplate opposite results. They were drafted by different groups, with different objects, and according to different models.

E. Rostow and L. Cutler, "Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act," Yale Faculty Scholarship Series, Paper 2149 (1939), available at http://digitalcommons.law.yale.edu/fss_papers/2149.

4. See "Companies in Chapter 11 Face Express Trip to Auction Block," *Wall Street Journal*, Jan. 14, 2013 at B1.
5. See Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. 109-8, 119 Stat. 23 (2005).
6. See http://www.abiworld.org/AM/Template.cfm?Section=About_ABI.
7. See http://commission.abi.org/purpose-commission.
8. The 13 study topics are administrative claims, critical vendors and other pressures on liquidity; avoiding powers; bankruptcy remote entities, bankruptcy-proofing and public policy; distributional issues under plans; executory contracts and leases; financial contracts, derivatives and safe harbors; financing Chapter 11; governance and supervision of Chapter 11 cases and companies; labor and benefits issues; multiple enterprise cases/issues; plan issues: procedure and structure; role of valuation in Chapter 11 cases; and sales of substantially all of the debtor's assets, including going concern sales.
9. These statements are available on the commission's website, http://commission.abi.org/.
10. __U.S.__, 132 S.Ct. 2065 (2012). The court did not consider the merits of credit-bidding. 132 S.Ct. at 2073.
11. "Statement of Commissioner Kenneth N. Klee," April 19, 2012, at 1, available at http://commission.abi.org/. Interestingly, while the ABI is considering curtailing secured party rights in bankruptcy, the recent proposal to update and modernize the European Insolvency Regulation would preserve the safeguards that secured creditors currently have without impairment. Commission Proposal for a Regulation of the European Parliament and of the Council Amending Council Regulation (EC) No. 1346/2000 on Insolvency Proceedings, COM (2012) 744 final (Dec. 12, 2012).
12. "There's been an assumption by some, an incorrect one, that because [the commission] identified those two externalities—claims trading and the growth of secured debt—that we were identifying them as problems to be solved." "Bankruptcy Commission: Secured Lending OK by Us," CFO J., Dec. 4, 2012 (quoting cochair Robert Keach).
13. See, e.g., "Loan Group Warns Over Creditors' Bankruptcy Rights," *Wall Street Journal*, Nov. 12, 2012.
14. See, e.g., "First Report of the Commercial Finance Association to the ABI Commission to Study the Reform of Chapter 11," Nov. 15, 2012, available at http://commission.abi.org/, which indeed asserts that the commission should use this opportunity to amend the code provisions so as to clarify, reaffirm and enhance certain identified secured creditor rights.

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