

Erosion of Secured Creditors' Rights: Has the Pendulum Swung in Favor of Unsecured Creditors

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Courts are now being asked to examine transactions which were completed during the recent exuberant period. Despite the fact that the transactions in question may have been market standard at the time, because those transactions are being scrutinized during an unprecedented economic crisis, it appears that a disproportionate amount of finger pointing – and economic loss – is being directed at secured creditors. The result is a seeming erosion of secured creditors' rights for the benefit of unsecured creditors. Some recent decisions appear result oriented, often upsetting long established principles. This article will examine how long standing doctrines – such as the right to credit bid and the right to object to a plan of reorganization – that protected secured creditors have been altered. Although some of these decisions are being appealed, we believe these decisions support the assertion that secured creditors' rights are being eroded. The question remains, how far has the pendulum shifted and is it permanent?

Executive Summary

The ability to credit bid the secured claim in connection with a sale of secured creditors' collateral is one of the fundamental rights and protections afforded to secured creditors. But in the *Philadelphia Newspapers* case, the court held that secured creditors do not have an absolute right to credit bid if the sale of the collateral occurs pursuant to a plan of reorganization, as opposed to a sale under section 363 of the Bankruptcy Code. Although the decision is on appeal, it could have a significant impact on the treatment of

secured creditors in bankruptcy and erode a fundamental right of secured creditors.

In the *Chrysler* bankruptcy case, the debtors were able to bypass the requirements of the Bankruptcy Code and provide a greater recovery to unsecured creditors than to secured creditors. The *Chrysler* debtors were able to do this by conducting a rapid 363 sale of their assets to a "newco" which was created to facilitate just such a result. The newco paid \$2 billion in cash for the assets of Chrysler, which amount was distributed to the secured creditors, resulting in a recovery of approximately 29%. However, newco also issued the majority of its membership interests to Chrysler's unsecured creditors (including retirees) and also agreed to provide a new \$4.6 billion note to Chrysler's retirees, resulting in recoveries ranging from 50% to 100% for unsecured creditors. The court approved this sale notwithstanding that the auction procedures ensured that there would be no true market test for the assets that were sold and the "sale" was nothing more than a "sub rosa" plan that could not have been confirmed under the requirements of the Bankruptcy Code. It remains to be seen whether the *Chrysler* case is an anomaly resulting from the extraordinary crisis impacting the auto industry and the economy or if it will provide a blueprint for others to skirt the requirements of the Bankruptcy Code and provide greater recovery to unsecured creditors at the expense of secured creditors.

Two recent fraudulent transfer cases - *TOUSA* and *Crown Stock* - serve as cautionary reminders of the dangers that secured creditors face and the steep costs they will

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incur if it is determined that a fraudulent transfer has occurred. In both of these cases, the courts found the elements of a fraudulent transfer to exist and, as a result, looked to restore the debtors to the financial condition that would have existed if the transfer had never occurred. The courts fashioned far reaching remedies, including disgorgement of all payments, avoidance of liens and claims, and reimbursement of the debtors for all losses they may have suffered, in order to return the debtors to the *status quo ante*. The result of such remedies, as seen in the cases, is that value was extracted from secured creditors for the benefit of the debtors and, ultimately, the unsecured creditors.

Prohibiting Secured Creditors from Credit Bidding at Asset Sales

When debtors seek court authority to sell their assets as part of a 363 sale, Bankruptcy Code section 363(k) expressly provides that secured creditors have the right to credit bid their allowed secured claims at such a sale. In addition to selling assets as part of a 363 sale, debtors may also seek to sell their assets as part of a chapter 11 plan. According to the United States District Court for the Eastern District of Pennsylvania in *Philadelphia Newspapers*,² debtors have the right to prohibit a credit bid by the secured creditors in connection with a sale pursuant to a plan of reorganization.

In *Philadelphia Newspapers* an investor group acquired the debtors in 2006, funding a majority of the purchase price with a secured loan. By March 2009, the debtors filed for bankruptcy and thereafter proposed a plan of reorganization that provided for a sale of the operating assets of the debtors. Specifically, the debtors’ plan of reorganization proposed (i) conducting a public auction for all assets other than their real property, (ii) transferring the real estate to the secured lenders, (iii) creating a \$1.2 million liquidating trust in favor of general unsecured trade creditors, and (iv) distributing 3% of the equity

interests in the successful bidder at the auction to certain holders of unsecured claims if the secured lenders waived certain subordination rights.

In furtherance of the auction, the debtors entered into an asset purchase agreement with a stalking horse bidder. The cash proceeds that would be available to the secured lenders under the asset purchase agreement totaled \$36 million. If the auction resulted in competitive bidding the secured lenders would receive the benefit of any overbids. Incredibly, the stalking horse’s equity owners owned approximately 30% of the investor group and the stalking horse’s chairman had until just prior to the auction owned approximately 20% of the investor group.

The proposed plan of reorganization also provided for the transfer of certain real property the Debtors valued at \$30 million to the secured lenders. As a result, the secured lenders were facing the prospect of significant losses.

Because the plan of reorganization did not provide for payment in full to the secured creditors and the secured creditors were opposed to the plan, the plan would have to be crammed-down on the secured creditors. The Bankruptcy Code provides several ways in which debtors can attempt to cram-down a secured creditor. Two are relevant with respect to asset sales and were the subject of the Court’s analysis. The debtors may either (i) sell the assets subject to the secured creditor’s right to credit bid under section 363(k), with the liens attaching to such proceeds (the “Sale Prong”), or (ii) demonstrate that the plan of reorganization provides the secured creditor with the “indubitable equivalent” of such claims (the “Indubitable Equivalent Prong”).

The debtors argued that because section 1129 was written in the disjunctive, they could proceed under the Indubitable Equivalent Prong, and not the Sale Prong, without offering section 363(k) credit bid protections because those protections are only required if debtors seek confirmation under the Sale Prong. The

² *In re Philadelphia Newspapers, LLC*, Case No. 09-mc-178 (ECR), [Dkt. No. 21] (E.D. Pa. Nov. 10, 2009).

Bankruptcy Court rejected this argument based largely on (i) the fact that the Sale Prong specifically addressed the debtors' proposed course of conduct and requires credit bid protection and (ii) policy grounds which clearly favored protecting secured creditors' right to credit bid.

On appeal, the District Court reversed the Bankruptcy Court and held that debtors could prohibit secured creditors from credit bidding if the debtors propose to confirm a plan under the Indubitable Equivalent Prong and not the Sale Prong because the two prongs are disjunctive.

In order to confirm the plan of reorganization, however, the District Court noted that the debtors would have to demonstrate that providing the secured creditors with proceeds from an auction where the secured creditors were prohibited from credit bidding was the "indubitable equivalent" of providing them with proceeds or assets from an auction where they could credit bid. In other words, the secured creditors could argue that as a result of the restriction on credit bidding, the auction failed to generate fair market value and therefore the debtors could not provide them with the indubitable equivalent. Although the District Court acknowledged that credit bidding, and even the threat of a credit bid, helps to ensure that assets are being sold at fair market value, the secured creditors will nonetheless have difficulty demonstrating that the court approved auction failed to generate fair market value.

Because the District Court's opinion was based upon the plain language of section 1129, the fact that the stalking horse bidder was owned in part by parties that owned equity in the debtors had no bearing on the District Court's opinion. Rather, the District Court held that the propriety of a potential "insider transaction" would have to be addressed at the plan confirmation hearing.

Although the District Court's opinion has been appealed, it could have significant impact on

restructurings and, as the Bankruptcy Court feared, erode fundamental secured creditors' rights in ways not previously contemplated because there is little difference between what was proposed by the debtors in this case and a section 363 sale.

Distribution of Collateral Value to Junior Classes Under a *Sub Rosa* Plan

The *Chrysler* decisions,³ if followed by other courts, represent a potentially significant erosion of one of the bedrock principles underlying secured financing -- that a 363 sale cannot act as a *sub rosa* plan, *i.e.*, determine distributions to and the priority of creditors that would ordinarily be determined in a plan of reorganization under Bankruptcy Code section 1129. Under section 1129, a plan of reorganization must either be consented to by the secured creditors or must provide that the present value of payments to secured creditors equal or exceed the value of their collateral. In addition, any deficiency claims remaining after payment of the secured portion of their claims would be entitled to *pro rata* treatment with all other unsecured creditors.

In *Chrysler*, the majority of the operating assets were transferred to New CarCo Acquisition LLC ("New Chrysler"), a newly formed Delaware LLC and an indirect wholly owned subsidiary of Fiat S.p.A. New Chrysler paid Chrysler \$2 billion in cash in exchange for the assets, which payment was distributed to the secured creditors. New Chrysler also issued 55% of the membership interests in New Chrysler to the retirees of Chrysler and approximately 10% of the membership interests to the U.S. Treasury and the Canadian government. New Chrysler also agreed to provide a note to the retirees for an additional \$4.6 billion.

It is clear that the ultimate result of the transaction could never have been confirmed under Bankruptcy Code section 1129 in that in exchange for the assets of Chrysler, New Chrysler was providing secured creditors with a recovery of approximately \$0.29 per dollar of claim whereas unsecured creditors were receiving recoveries ranging from \$0.50 per dollar of claim to

³ *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009), *aff'd* 576 F.3d 108 (2d Cir. 2009).

payment in full. Nevertheless, neither the Bankruptcy Court nor the Second Circuit viewed the transaction as being a *sub rosa* plan or one where collateral value was being distributed to junior unsecured classes because (i) the recoveries to unsecured creditors were not being provided by the Debtors under a plan of reorganization but rather were voluntarily being assumed by a third party buyer, (ii) the Bankruptcy Court determined that the secured creditors were receiving the full value of their collateral and (iii) the secured lender class had consented to the sale.

Although there are many cases where a third party buyer will agree to assume in the ordinary course certain unsecured obligations of the seller as a condition to the sale notwithstanding the payment of less than full amount of the secured creditors' claims, the problem in *Chrysler* was that: (i) the value of the secured creditors' collateral was never seriously tested in the bankruptcy proceeding through a market auction given the "emergency" timeline imposed on the Bankruptcy Court; (ii) bids were only accepted for all of the assets and only if all of the same liabilities would be assumed; (iii) there was no real third party buyer as New Chrysler was owned and controlled by the very creditors being preferred under the sale agreement; (iv) the obligations being assumed (including retiree benefits) could not in any rational manner be tied to the economics of the transaction as no real third party buyer would have assumed such liabilities and (v) approximately 70% of the "consenting" secured creditor class were recipients of TARP funds and not necessarily in a position to challenge the U.S. Treasury's wishes.

As a result of the Bankruptcy Court's and Second Circuit's reluctance to view "New Chrysler" for what it was -- an instrumentality of Chrysler's existing creditors, including the United States Treasury-- there may be little to deter others from employing similar structures through the use of a fast track, market untested section 363 sale to attempt an end around the

requirement of Bankruptcy Code section 1129 that would prohibit such a result in a plan of reorganization.

Following the *Chrysler* precedents, perhaps nothing would stop management of a debtor from entering into an agreement with junior lenders or creditors to create a newco to purchase the assets of "oldco" and assume the junior obligations while providing the senior lenders with a less than full recovery. Although courts hopefully insist on a "true" market test for newco's purchase, such a market test may be manipulated by both the timing for the sale and the conditions attached to the sale procedures. Until there is greater clarity as to whether bankruptcy courts will view *Chrysler* and, for that matter, *General Motors*, as anomalies resulting from the extraordinary crisis impacting those bankruptcies, these decisions add to the general uncertainty being felt by secured lenders.

Fraudulent Transfer Claims: Extraordinary Remedies to Unwind the Transfers

Fraudulent transfer claims are often asserted against secured creditors by unsecured creditors to obtain a recovery or leverage in a bankruptcy case. Such claims are relatively easy to bring but difficult and expensive to litigate due to their fact intensive nature. The recent *TOUSA*⁴ and *Crown Stock*⁵ decisions, however, have called into question the enforceability of the widely used insolvency "savings clauses" and highlight the risk of sweeping remedies that may be imposed against secured creditors if a court finds that a fraudulent transfer has occurred.

Generally, prepetition transfers of a debtor's assets can be avoided if there was actual fraud or constructive fraud. Actual fraud requires actual intent on the part of the debtor to hinder, delay or defraud creditors. On the other hand, constructive fraud can be construed to exist if (i) the debtor received less than reasonably equivalent value in exchange for the transfer and (ii) the debtor (A) was insolvent at the time, or became insolvent as a result, of the transaction, (B) was

⁴ Official Comm. of Unsecured Creditors of *TOUSA, Inc. v. Citicorp North America, Inc. (In re TOUSA, Inc.)*, Adv. Pro. No. 08-1435-JKO (Bankr. S.D. Fla., Oct. 13, 2009).
⁵ *Boyer v. Crown Stock Distrib., Inc.*, No. 09-1699 (7th Cir., Nov. 18, 2009).

engaged in business for which it possesses an unreasonably small amount of capital or (C) intended to incur debts beyond its ability to pay as they matured.

The TOUSA Decision

TOUSA had guaranteed certain unsecured loans owed by a joint venture to a group of lenders. The joint venture defaulted on the loans and its lenders sued TOUSA on the guaranty. TOUSA ultimately settled the litigation and agreed to pay approximately \$420 million to the joint venture lenders.

In order to finance the settlement, TOUSA borrowed \$500 million in first and second lien facilities in July 2007. The new loans were secured by liens on substantially all of TOUSA's and its subsidiaries' assets. Significantly, the subsidiaries who pledged their previously unencumbered assets as security for the new loans were not obligated to the joint venture lenders and were not parties to the litigation or the settlement. These subsidiaries also did not receive any of the proceeds of the new loan. As the Bankruptcy Court noted, the transactions in essence swapped an unsecured liability of TOUSA, the parent entity, for a secured liability of TOUSA and its subsidiaries.

TOUSA and its subsidiaries filed for bankruptcy protection under chapter 11 of the Bankruptcy Code on January 29, 2008, approximately six months after the transactions involving the new loans and the settlement with the joint venture lenders. In the bankruptcy proceeding, the unsecured creditors' committee brought an action against both the new lenders and the joint venture lenders, seeking to avoid these transactions and transfers as fraudulent transfers.

The Bankruptcy Court determined that the transfers in question were fraudulent transfers and specifically found that the subsidiaries (i) did not receive reasonably equivalent value in exchange for the obligations they incurred and the transfers they made and (ii) (A) were insolvent both before and after the

transactions, (B) were left with unreasonably small capital to operate their business, and (C) were unable to pay their debts as they came due. The Bankruptcy Court also noted that the subsidiaries received none of the proceeds of the new loans and received no direct or indirect benefit from the payoff of the obligations owed by TOUSA to the joint venture lenders.

The Bankruptcy Court rejected the lenders' reliance on the "savings clauses" in the new loan documents, which purported to reduce the amount of the subsidiary guarantees to the extent necessary to prevent the subsidiaries from becoming insolvent. The Bankruptcy Court found the saving clauses to be inherently indeterminate and unenforceable for a variety of reasons. Significantly, the Bankruptcy Court found that savings clauses were unenforceable efforts to contract around the core provisions of the Bankruptcy Code and invalid. In particular, the Bankruptcy Court stated that savings clauses are a frontal assault on fraudulent transfer protections and entirely too cute to be enforced. The Bankruptcy Court also found the solvency opinion that was issued at the time of the transactions to be unpersuasive and not credible, and rejected the lenders' "good faith" defense to the fraudulent transfer claims, finding that the lenders had more than sufficient notice of TOUSA's insolvency based upon objective, publically available information.

Accordingly, the Bankruptcy Court (i) avoided and disallowed (A) the obligations incurred by the subsidiaries to the lenders for the new loan, (B) the liens granted to secure those obligations, and (C) all claims asserted or assertable by such lenders against the subsidiaries, (ii) ordered the disgorgement by the new lenders of all payments of principal, interest and fees and (iii) also avoided and ordered the joint venture lenders to disgorge \$403 million (which was the amount attributable to the subsidiaries), plus interest, they had received in settlement payments from TOUSA.

The Bankruptcy Court then went on to hold that a complete remedy for fraudulent transfer required that the estate be restored to the financial condition that would have existed had the transfer never occurred. As a result, to unwind the transaction and provide compensation to the subsidiaries, the Bankruptcy Court ordered that the subsidiaries could recover from the amount disgorged by the joint venture lenders (i) the costs they incurred as a result of the transfers, including the costs associated with the loan transaction with the new lenders and the costs of prosecuting the fraudulent transfer litigation and (ii) the diminution in the value of their assets between the date of the granting of the liens to the new lenders and the date of the Bankruptcy Court's decision. Any amount remaining from the funds disgorged by the joint venture lenders, after these payments to the subsidiaries, would then be distributed to the new lenders.

The Crown Stock Decision

In *Crown Stock*, the Seventh Circuit Court of Appeals affirmed the Bankruptcy Court's and the District Court's finding of a fraudulent transfer, avoided the entire transfer at issue and granted additional relief to the bankruptcy trustee against the defendants, a defunct corporation and its shareholders. In the case, a newly formed buyer paid \$6 million (\$3.1 million in cash, which buyer borrowed from a bank by pledging the purchased assets as collateral, and \$2.9 million in a note) for the assets of the seller. The entire \$3.1 million in cash was distributed to the seller's shareholders following the sale. Three and a half years after the transaction, the buyer declared bankruptcy.

The Bankruptcy Court in *Crown Stock* had ruled that the buyer did not receive reasonably equivalent value in exchange for the \$6 million purchase price. This finding was based upon the Bankruptcy Court's view that the assets purchased were worth no more than \$4 million on the date of the closing. As a result, Bankruptcy Court found that the buyer had embarked

upon a business for which its remaining assets were "unreasonably small in relation to the business."

Based upon the finding of a fraudulent transfer, the Court of Appeals affirmed the avoidance of the transaction, ordered the seller and its shareholders to return the \$3.1 million cash purchase price they received, along with \$200,000 in interest payments on the note. In affirming and ordering these far reaching remedies, the Court of Appeals stated that the next stage after finding a fraudulent transfer was to restore to the debtor the money that the debtor had paid for the assets. The seller argued that the buyer was receiving a windfall because the seller was not getting any credit for the assets that were actually sold to the buyer, which assets had been sold by the bankruptcy trustee for \$3.7 million. The Court of Appeals rejected the seller's windfall argument, simply noting that if the unsecured creditors in the case are paid in full, after payment of the secured loan to the bank and after payment of the costs of administering the bankruptcy, then any money remaining in the estate would go to the defendants.

TOUSA, which is currently on appeal, and the *Crown Stock* decisions represent rare instances of fraudulent transfer claims being litigated to conclusion and they show the significant risks that are inherent in fraudulent transfer claims and the far reaching remedies that may be ordered by courts in order to restore the debtors to the financial condition that would have existed had the transfer never occurred. Creditors must pay close attention to the solvency of the borrower and any guarantor and need to be aware of the heightened risks they face when they engage in transactions with financially distressed companies. As seen in *TOUSA* and *Crown Stock*, if the elements of constructive fraudulent transfer are present, it is difficult, if not impossible, to document around or protect against fraudulent transfer risks and the sweeping avoidance and disgorgement remedies that may be imposed against the secured lenders.

CONCLUSION

Each of the cases discussed above supports the assertion that secured creditors' rights have been eroded. From secured creditors' point of view, it is particularly alarming that the courts applied remedies or made determinations which effectively, and more importantly, economically, disregarded the rights and protections afforded secured creditors and appear to be punitive in nature. These courts have seemingly accepted unsecured creditors' argument that secured creditors are the culprits for this economic crisis. Although we cannot know for certain how these decisions will fare on appeal, it is clear that, at least for now, the pendulum has seemingly shifted away from secured creditor protection towards recoveries for unsecured creditors. What remains to be seen is whether such shift is permanent and if we will see further swings in favor of the debtors and unsecured creditors.

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