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Is the **Tide Turning** Against Secured Creditors?

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A GIVEN for bankruptcy lawyers is that secured creditors typically control the bankruptcy process. Although bankruptcy courts are a haven for debtors seeking relief, at least temporarily, from secured and unsecured creditors alike, a debtor with substantially all of its assets encumbered by liens has little wiggle room.

A debtor is limited in its use of encumbered cash (i.e., cash collateral) in bankruptcy to manage its business and pay its professionals absent approval of its secured creditors. A debtor is also limited in obtaining additional credit, particularly new credit that seeks to prime existing secured claims, without a trial to determine a host of issues, including whether the lender is adequately protected (i.e., there is a cushion to ensure that the lender's collateral will not diminish in value as a result of the extension of new credit). See, e.g., §§363 and 364 of title 11, Chapter 11 of the U.S. Code (Code).

However, bankruptcy judges wield tremendous power in interpreting Code provisions in the context of a court of equity where principles of fairness are as important as principles of law. This power was most evident in *Official Comm. of Unsecured Creditors of Tousa Inc. v. Citicorp N. Am. Inc. (In re Tousa)*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), where a bankruptcy judge set aside as fraudulent conveyances "transfers" of cash and liens on property ostensibly made by certain subsidiaries of Tousa Inc.

Even where the bankruptcy court acts predictably, appellate courts sometimes rule against the secured creditor, which happened in *In re Phila. Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), where the Third Circuit rejected the statutorily based argument that secured lenders have the right to credit bid at an auction conducted through a plan, and *Clear Channel Outdoor Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (9th Cir. BAP 2008), in which the Ninth Circuit Bankruptcy Appellate Panel (BAP) significantly weakened the good faith purchaser protections in auction sales pursuant to Code §363.

Is the tide turning against secured creditors in response to the significant decline in value of property encumbered by their liens (prompted by the economic crisis), and the apparent lack of options for reorganization other than to turn over property to secured creditors?

Taking 'Tousa' as an Example

The fraudulent transfers in *Tousa* were made in connection with the settlement of a lawsuit brought by certain lenders (the "Transeastern Lenders") against Tousa and one of its subsidiaries (the "Original Borrowers") for, inter alia, breach of loan agreements and damages relating to Tousa's failing 2005 Transeastern Joint Venture. *Tousa*, 422 B.R. at 789. The settlement resulted in the repayment of $421 million to the Transeastern Lenders and the extension of new loans by some of the Transeastern Lenders and some new lenders (collectively, the "New Lenders") secured by first and second liens on substantially all of the assets of Tousa and its subsidiaries, all but one of which were not Original Borrowers (the new subsidiary borrowers are known as the "Conveying Subsidiaries"). Id.

In a nearly 200 page decision, the bankruptcy court held that the liens granted to the New Lenders were fraudulent conveyances because, inter alia, the Conveying Subsidiaries were insolvent when the new loans were made, and did not receive reasonably equivalent value or any direct benefit in exchange for the liens. Id. at 844-48.

To return all parties to the positions they held before the new loans closed, the bankruptcy court ordered:

(i) the avoidance of the liens of the New Lenders,

(ii) remittance by the New Lenders to the Conveying Subsidiaries of

(a) the diminution in value of the collateral, because the liens theoretically prevented the Conveying Subsidiaries from selling assets encumbered by the New Lenders,

(b) interest and attorneys fees paid to the New Lenders, and

(c) attorneys fees, interest and costs of the Conveying Subsidiaries,

(iii) disgorgement by the Transeastern Lenders of $403 million (the payment to it that the court attributed to the Conveying Subsidiaries), plus prejudgment interest, into a fund, the proceeds of which will pay the fees and costs due to the Conveying Subsidiaries with the remainder to be repaid to the New Lenders, and

(iv) the reinstatement of the Transeastern Lenders' unsecured claim against the Original Borrowers. Id. at 884-87.

But the bankruptcy court went a step further in stating that the standard "savings clause," which automatically reduces the debt of a borrower to the extent that the debt would render the borrower insolvent, did not allow any of the lenders to avoid a finding of fraudulent transfer.

The court reasoned that savings clauses impinge on the property rights of a debtor and prevent the debtor from pursuing fraudulent conveyance actions under Code §§541 and 548, which the court found "inherently distasteful." Id. at 863-64 ("…savings clauses are a frontal assault on the protections that section 548 provides to other creditors. They are, in short, entirely too cute to be enforced.")

The length, tone and detail of the decision reflect the judge's ire at the alleged "bad facts" revealed during the 13 day trial, which included a significant internal memo from Tousa's management to the company advising against the new loan transactions, Tousa's advisor's advice to file for bankruptcy protection rather than entering into a rushed transaction in a down market that would inevitably lead to bankruptcy in the short term, and the lenders' financial advisor's solvency opinion rendered on a contingency fee basis (with a significant upside for a favorable opinion) relying solely on data provided by the company that an analysis of market conditions revealed was flawed.

Fortunately, the detail helps to distinguish this case from future cases involving similar issues.

The *Tousa* decision, not surprisingly, was appealed. See *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors*, 0:10-cv-

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060017, in the U.S. District Court for the Southern District of Florida.

The Transeastern Lenders and the New Lenders filed their briefs on June 1 in support of their separate appeals, arguing that the bankruptcy court's decision was erroneous both on the facts and the law. See Appeal Brief of the Transeastern Lenders, Case No. 0:10-cv-60017-ASG (S.D. Fla. June 1, 2010); Initial Brief of the Second Lien Appellants, Case No. 0:10-cv-60018-ASG (S.D. Fla. June 1, 2010); Opening Brief of First Lien Appellants, Case No. 0:10-cv-60019-AJ (S.D. Fla. June 1, 2010).

Among other things they argue that:

(i) the Conveying Subsidiaries were solvent at the time of the transfers, and received significant and equivalent benefits in exchange for the new loans because, among other things, they had no ability to generate liquidity separately,

(ii) disregarding the testimony of lenders' qualified expert appraisers and relying upon a non-expert, who was not a licensed appraiser, was reversible error,

(iii) the Conveying Subsidiaries had no property interest in the new loan proceeds transferred to the Transeastern Lenders, such that disgorgement would be improper, and

(iv) the Chapter 7 liquidation analysis attached to a draft of the debtor's plan (subsequently abandoned), which formed the basis for the bankruptcy court's decision, was flawed and unreliable.

This decision raises many interesting bankruptcy issues. Whether or not overturned on appeal, the bankruptcy court's comments regarding "savings clauses" and attempts generally to draft around language of the Code will remain and may be considered by another court in rendering an opinion in another jurisdiction. As the Transeastern Lenders note in their appellate brief, the *Tousa* decision may at least chill out of court loan restructurings, a potentially disastrous and costly result.

Limiting Credit Bidding

In *Philadelphia Newspapers*, the Third Circuit held that a secured creditor can be barred from credit bidding the amount of its debt to recover its collateral at a bankruptcy sale conducted through a plan. In that case, the debtor sought to sell substantially all of its assets at an auction sale conducted pursuant to a plan. *Philadelphia Newspapers*, 599 F.3d at 301-02.

The debtor selected a group comprised in part of the owners of the debtor as the stalking horse bidder, and sought to prevent the secured creditors from credit bidding in their debt at the auction sale. Id. at 302. The bankruptcy court held that the secured creditors were entitled to credit bid. See id. Ultimately, the Third Circuit overturned that decision.

Section 1129(b) allows a debtor to confirm (i.e., obtain approval for) a plan that meets all other criteria for confirmation except the requirement that each "impaired" class (a class whose claimants will not be paid in full) has accepted the plan. 11 U.S.C. §1129(b). This section allows the debtor to "cram down" the creditors and confirm its plan.

Section 1129(b)(2)(A)(ii) authorizes a debtor to sell property free and clear of secured creditors' liens at an auction conducted pursuant to Code §363(k), which specifically allows credit bidding by secured creditors unless the bankruptcy court "for cause" orders otherwise. In the alternative, §1129(b)(2)(A)(iii) authorizes a debtor to confirm a plan that provides secured creditors with the "indubitable equivalent of [their] claims."

Significantly, the Third Circuit held that the disjunctive "or" between (A)(ii) and (A)(iii) gave the debtor the option to proceed with an auction allowing the secured creditor to credit bid, *or* conduct the auction and distribute to the secured creditor the "indubitable equivalent" of its claims. 599 F.3d at 305.

In the dissenting opinion, Judge Thomas Ambro, a former bankruptcy lawyer, was critical of the majority's decision to ignore the principle of following the specific over the general: (A)(ii) is specific with respect to auction sales and, therefore, should be relied upon when conducting an auction, while (A)(iii) is a general provision that, following this decision, seemingly makes (A)(ii) irrelevant. Id. at 319, 320-38 (Ambro, J., dissenting).

While the majority of the Third Circuit declined to hold that proceeds of an auction constitute the indubitable equivalent to the secured lender, it is hard to imagine that one does not follow from the other. At least for now in the Third Circuit, secured creditors must be prepared to (i) bid actual dollars to recover their collateral, as the secured creditors ultimately did in this case (a mere formality since the cash should return to the secured creditor unless a portion of the funds paid is used to pay a break up fee or other administrative expense of the estate), (ii) act earlier than plan confirmation to foreclose (e.g., pursue relief from stay), or (iii) challenge a proposed plan.

In the Context of §363 Sales

The Third Circuit case was in the context of a plan. *Clear Channel* was in the context of a §363 sale.

In that case, first lien lender Deutsche Bank was the successful bidder (through a credit bid of its secured debt) at an auction pursuant to §363 that extinguished the lien of Clear Channel, the second lien lender. *Clear Channel*, 391 B.R. at 31. Notably, the sale order authorized the sale free and clear of all liens and contained the requisite specific reference to §363(m), declaring the sale final and Deutsche Bank a good faith purchaser even in the event the sale is overturned in the future. The bankruptcy court denied Clear Channel's request for a stay of the sale and the sale to Deutsche Bank was consummated.

The Ninth Circuit BAP held that §363(m) protected only the validity of the sale, thus preventing it from being overturned, but did not protect the purchaser from a reversal (and eventual alteration) of the underlying terms of the sale, even the material term that the property be sold free and clear of junior liens. Id. at 33-37. Of course, this is a devastating result for 363 purchasers in the Ninth Circuit.

The Ninth Circuit BAP went further to hold that the plain meaning of §363(f) allowed a sale free and clear only if the sale price exceeds the face value of all liens. Id. at 41. This finding effectively would prevent a sale free and clear without consent in every instance where collateral has declined in value to the point where the secured creditor is undersecured. The BAP cited a New York bankruptcy court case in support of its finding that is still good law despite the many sales free and clear that have occurred since (*In re Gen. Bearing Corp.*, 136 B.R. 361 (Bankr. S.D.N.Y. 1992)).

The likely result is that fewer sales will be conducted through the 363 process in the Ninth Circuit, or the 363 sale will not be consummated until the order approving the sale is final and any objections have been fully and finally resolved.

Conclusions

What is the import of these decisions?

Certainly, debtors have leverage they previously did not have against secured creditors. Restructuring of loans pre-bankruptcy will be considered more carefully and lenders will take greater care in entering deals granting them additional collateral. And, in choosing where to file a Chapter 11 case, debtors will consider the precedent in the forum.

However, none of these decisions suggests that secured creditors have lost significant ground in bankruptcy cases. Even if *Tousa* is not overturned, the detailed decision following a lengthy trial makes that case unique and it is not precedent outside of that court.

Other options for secured lenders? A foreclosure action, receivership, or a sale pursuant to the Uniform Commercial Code when, for example, the collateral is shares in an LLC. State receivership law is often old and there are few reported cases, but in many states a receiver has rights similar to a debtor or trustee to reject contracts.

The powers of a receiver are typically those granted in a receivership order drafted by the secured lender. Moreover, the receiver is appointed or at least recommended by the secured lender and acts at the lender's direction, such that a secured lender may wield more power in receivership than in a bankruptcy.

Of course, the commencement of any or all of these actions will not prevent the filing by a borrower/debtor of a voluntary petition under the Code that has the effect of staying a pending action against the debtor. Therefore, the secured lender may be right back in bankruptcy court fighting for its rights; a fight that before the economic downturn came easier.