Highly leveraged companies in distress beware: expect your secured creditors to exert more control

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While the current liquidity crisis has echoes of prior economic downturns, the restructuring and insolvency of highly leveraged companies in this cycle will not follow the pattern of prior cycles. Here the problems appear to be more widespread, affecting all industrial and financial sectors. Recent reports have indicated that corporate bond defaults, largely non-existent for the last several years, will increase exponentially in 2008, perhaps to as much as $35 billion in defaulted corporate bonds. What makes this economic downturn so memorable is the speed at which the markets have collapsed and concern about how long the economic turmoil will last.

There are other reasons why this cycle is going to be unlike all that have preceded it. First, borrowers are more leveraged than ever before. As a consequence, there will be few, if any, unencumbered assets available to distribute to unsecured creditors or equity holders.

Second, there are few alternative sources of financing for troubled companies – private equity and hedge funds will likely be the primary source of financing for troubled companies. Many of these lenders are themselves encountering financial challenges because of the large number of troubled companies within their portfolios. Nonetheless, in order to preserve their initial investment, these firms may be compelled to extend additional or new credit or refinance existing credit lines to their troubled portfolio companies. During the last few years troubled companies were able to postpone the need for any financial restructuring. As credit was readily available, lenders were willing to make loans or refinance existing financing on terms that were devoid of the usual covenants and financial triggers, so-called 'covenant-lite' agreements. With tightened liquidity, refinancing of existing credit lines will not be so easily accomplished as in the last few years.

Third, a financially distressed company may be compelled to commence bankruptcy proceedings in order to restructure its debt. The widespread use of the capital markets to trade corporate bond debt or loans (through securitisation vehicles, credit default swaps or other capital market transactions) makes it difficult, if not impossible, to identify holders or effect an out-of-court consensual restructuring. Most bond indentures and loan agreements require unanimous consent of all holders in order for a company to change the maturity dates or amortisation schedules, modify interest rates, release liens or make other changes to the economic terms. Modifications to loan covenants and the like also usually require majority or super-majority consent of holders. In the last few years, with the increased use of capital markets, most companies do not know who holds their public debt or loans or their percentage of holdings. Commencement of bankruptcy proceedings may be the only means for a distressed company to solicit sufficient consent to the financial restructuring of their debt and loan obligations.

Finally, the rights of secured creditors are greater now as a result of recent changes to the US Bankruptcy Code and commercial law. Thus, secured creditors will have more opportunity to control the process and terms of any restructuring. This chapter addresses how secured creditors exercise their

rights and remedies to take control over the restructuring and bankruptcy process.

Secured creditors' rights prior to bankruptcy: new strategies

Most transactions in recent years were carried out on a highly leveraged basis. As security for these transactions, lenders required borrowers to pledge all or substantially all of their assets. Parties to the transactions also arranged for financing at all levels of the capital structure through second-lien and mezzanine financing. In these transactions, equity owners of operating companies obtained financing by pledging the equity owners' interest in the operating company borrowers – for example:

- if the operating company was a corporation, a pledge of the corporate shares;
- if the operating company was a limited liability company, a pledge of the membership interest in the operating company; or
- if the operating company was a partnership, a pledge of the partnership interest.

As a consequence, lenders have security interests in all assets of the operating company, as well as pledge in the equity interests in the operating company.

In dealing with a troubled company, the lender or secured creditor should first determine what assets, if any, secure repayment of the amounts owed to it and what are the secured creditor's rights. The secured creditor should ask the following initial questions:

- Does the secured creditor have a pledge by the borrower of all of its assets or only certain specified assets?
- Where in the capital structure are the borrower and the pledgor(s)?
- What are those assets – real estate, personal property or both?
- If personal property, what type of personal property – accounts, inventory or securities?
- What priority does the secured creditor have in the pledged collateral – first, second or other?
- Does any other creditor have a lien on the same collateral?
- If so, is there an inter-creditor agreement that defines the rights of the secured creditors in regard to each other?
- What other collateral or credit enhancement exists to protect the lender's claims against the borrower? For example, does the secured creditor have a pledge by the borrower's equity owners of their interests in the borrower?
- What are the cash needs of the borrower on a weekly, monthly and quarterly basis for ordinary and necessary operating expenses and what revenue is projected to be generated during the next two years? How quickly will a cash infusion be necessary?
- Is the borrower likely to survive or does it need to find a strategic or financial buyer?

After responding to these questions, the secured creditor should then review its documents to determine its rights and remedies. Generally speaking, security interests in personal property are governed by state law, principally Article 9 of the Uniform Commercial Code (UCC), which has been adopted, with limited modifications, by every state. Article 9 covers most types of consensual security interest in personal property.

Upon a default, a secured creditor has multiple remedies with respect to personal property that has been pledged as collateral (eg, it can repossess the personal property, proceed to judicial foreclosure or conduct a non-judicial sale of the personal property collateral). There is no election of remedies with respect to personal property collateral. After default, a secured creditor may collect from account debtors or offset amounts on deposit in bank accounts with it against the borrower's obligations to it under the loan documents or indenture. If the lender has a pledge of the equity interests in the operating company and is concerned that the borrower may commence a voluntary bankruptcy case or sell its assets, upon default the lender may exercise its stock power or other contractual right to vote the pledged equity interests, thereby preventing a strategic bankruptcy filing by the company. Most pledge agreements provide for the lender to be able to exercise voting rights even before the lender has foreclosed on the pledged equity. Timing of the lender's exercise of remedies is critical. Most distressed companies are aware of the assignment of these voting rights and will attempt pre-emptively to file before any such voting rights can be exercised by the lender.

When a default occurs, the first action by a lender is to send a notice of default to the borrower (and any guarantors or other creditors that have a lien on the assets). The notice will also provide for acceleration of all the debt owed to the lender. The lender or secured creditor can then proceed to enforce its remedies against a borrower by foreclosing on the borrower's assets or, if the lender wants to maintain the going-concern value of the

borrower, by foreclosing on the pledge of equity interests in the borrower. In either event, recent changes to Article 9 of the UCC have made it easier for lenders to exercise their remedies upon a borrower default.

If the lender is not in possession of the collateral, the secured creditor is entitled to a limited use of 'self-help' – the right to take possession of the collateral without breach of the peace. Typically, the security agreement will provide that upon default, the secured creditor can demand that the borrower assemble and turn over the collateral to the secured creditor. Thus, for inventory, equipment or other goods pledged, the lender will first attempt to gain possession of the pledged collateral in order to foreclose upon it. For intangible collateral (eg, accounts receivable or other contractual rights to payment), upon default the lender may send notices to the account obligors to pay the lender directly, rather than the borrower. Usually, the secured creditor will exercise several of these options – requiring turnover of collateral by the borrower, notifying account debtors and applying cash on deposit against amounts owed to it.

If preserving equity is not possible, the borrower or its owners may be willing to step away from the transaction by simply 'turning over the keys' to the lender and walking away. In such event, the lender and the borrower may negotiate for a peaceful possession of the collateral to be turned over to the lender in full or partial satisfaction of the obligations owed to the lender. (This agreement is often referred to as a strict foreclosure.) Recent changes to Article 9 of the UCC make it possible for lenders to accept surrender of some or all of the collateral in partial satisfaction of the amounts owed to the lender. Prior to the revisions to Article 9, if the lender wanted the borrower to surrender collateral, it had to waive its right to any deficiency claim. Due to highly leveraged capital structures, a growing number of companies or their equity owners are simply turning over the keys to the lender and negotiating buy-outs of amounts owed to the lender under any guarantees. The advantage of strict foreclosure is the speed at which lenders obtain control of the distressed company or its assets and the avoidance of often time-consuming and expensive litigation in bankruptcy over valuation. The disadvantage is that the lender may find itself owning assets for which the market is illiquid.

Following a default, the secured creditor also may foreclose non-judicially by selling collateral by public or private sale. That foreclosure can be of some or all of the property pledged by the borrower or pledgor. The foreclosure is conducted without the commencement of litigation. Another significant change to commercial law that is favourable to lenders is the clarification of the rules for conducting a foreclosure sale of collateral. Prior to the recent revisions to Article 9 of the UCC, the notice period, the form of notice and the method of a public sale of collateral were uncertain. Now, unless the agreement between the borrower and the lender provides otherwise, the lender needs to provide only 10 days' notice prior to the public sale of the collateral. If the lender complies with the notice provisions set forth in Article 9 of the UCC regarding the time of the foreclosure sale, the parties to which notice should be provided and the provisions regarding the form and content of the notice, there is a presumption that the notice was adequate.

Thus, secured creditors have many remedies available after a default, some of which can be exercised quickly. If exercised prior to bankruptcy by the borrower (or pledgor, as applicable), the secured creditor can effectively take control over the distressed company or its assets. On the rare occasion where the lender is unable to repossess the collateral without breaching the peace and the lender does not have a perfected pledge of the equity interests in the borrower, the lender must proceed with judicial action. Typically, if that happens an out-of-court resolution cannot be achieved by the parties and the borrower will commence a voluntary Chapter 11 bankruptcy case. In that event, the secured creditor will be enforcing its rights as a secured creditor under the Bankruptcy Code.

Secured creditor rights after bankruptcy: new strategies

Secured creditors play a major role in Chapter 11 bankruptcy cases. Either they can work to free themselves and their collateral from the jurisdiction of the bankruptcy court, or they can work with the debtor (and any statutory committees appointed in the case) to confirm an acceptable plan. Most often, secured creditors work on both fronts at the same time.

The principal benefit which the company receives from filing for Chapter 11 is the automatic stay. Under the Bankruptcy Code, when a Chapter 11 petition is filed creditors are automatically stayed, or prevented, from taking action against the company or its property to collect debts arising before the day the bankruptcy case was filed

(referred to as 'pre-petition'). This automatic stay has the effect of a court-ordered injunction. It can be enforced by court order if necessary.

Types of action covered by the automatic stay include the following:

- commencing or continuing lawsuits against the company;
- modifying or terminating pre-petition contracts or declaring defaults under pre-petition contracts; and
- foreclosing or otherwise enforcing liens or mortgages on the company's property.

Creditors can apply to the bankruptcy court for an order modifying or vacating the automatic stay with respect to specific property of the debtor, or with respect to pending or proposed litigation. The bankruptcy court has considerable discretion in determining whether the stay should be modified or vacated. A creditor or other interested party can request relief from the stay from the bankruptcy court on either of two grounds:

- for cause, including a lack of adequate protection of an interest in property; or
- if the debtor lacks equity in the property and the property is not necessary to an effective reorganisation.

During the early stages of a Chapter 11 case, a bankruptcy court is generally reluctant to grant such relief. The bankruptcy court wants to provide the debtor with breathing room to enable it to determine what property is necessary to its reorganisation and what contractual agreements the debtor needs to maintain or reject. If the court allows a secured creditor to exercise remedies prematurely, the debtor may not have the property or contractual rights necessary to enable it to reorganise.

Typically, the secured creditor would consider the following options upon the commencement of a bankruptcy case:

- moving for relief from the automatic stay in order to foreclose on pledged collateral;
- moving for the appointment of a trustee or examiner (again, rarely granted at the commencement of the bankruptcy case);
- limiting the use of the lender's cash collateral; or
- voting for or against a plan, subject to the borrower's ability to obtain bankruptcy court approval of the plan over the lender's consent.

However, none of these provisions provides lenders with immediate or prompt relief. Indeed, such relief would not typically be granted during the early stage of a bankruptcy case (usually the first six months of the bankruptcy case, if not later). Recognising the difficulty of obtaining relief from the automatic stay, lenders would strive to complete foreclosure sales before the bankruptcy case is commenced.

Today, creditors generally, and secured creditors in particular, are expected to be more proactive in enforcing their rights and controlling the bankruptcy process. While a distressed company has control over the timing and venue of a bankruptcy case, recent bankruptcy cases demonstrate that secured creditors have control over the cash, thus enabling them effectively to control how the distressed company operates in bankruptcy. In so doing, the secured creditor has much more leverage in determining how the company is financially restructured.

The ways in which secured creditors effect control include the following:

- limiting the use of cash collateral;
- imposing stringent terms for debtor-in-possession loans (including shorter maturity dates); and
- enabling debtor-in-possession lenders to acquire the debtor or its assets through debtor-in-possession financing that converts into equity.

Funding of operations during bankruptcy: limitations on cash collateral

A debtor needs funds to pay its ordinary operating expenses (eg, payroll and suppliers of goods and services). Generally, a bankrupt company looks to two sources of funding of its post-petition operations. The first is use of cash collateral (eg, collections of accounts subject to security interests or proceeds from the sale of pledged inventory or equipment). Upon the filing of a bankruptcy petition, the debtor is required to account for and to segregate the creditors' cash collateral. The debtor is not permitted to use the cash collateral without the consent of the secured party or authorisation by the court after notice and a hearing. This protection is offered not by reason of any non-bankruptcy law limitations inherent to cash collateral, but rather in recognition of the unique nature of cash collateral and the risk to the secured creditor arising from the consumption of the cash in the debtor's efforts to reorganise.

Typically, a secured creditor and the debtor agree to a limited use of cash collateral for the

ordinary, necessary expenses of maintaining the collateral, with some or all of the excess cash (ie, the net operating income) being paid to the lender. Cash collateral agreements are most often structured to be without prejudice to the secured creditor taking such actions in the bankruptcy court as it might believe appropriate (eg, seeking to lift the automatic stay or move to convert or dismiss), and without prejudice to the debtor to attack the validity and perfection of the creditor's lien.

Generally, a secured creditor will allow the debtor to use a portion of cash collateral to pay administrative expenses, such as the professional fees and expenses of the case, up to a negotiated amount. This agreement is referred to as a carve-out. In recent years, secured creditors have dictated the use of cash collateral in ever-increasing ways. For example, secured creditors have prohibited the use of cash collateral to pay the professional fees and expenses of any professional other than the debtor's professionals. The courts have held that "[a] secured creditor may consent to the use of its collateral as it chooses" (eg, see *Debbie Reynolds Hotel & Casino, Inc v Calstar Corp, Inc (In re Debbie Reynolds Hotel & Casino, Inc)*, 255 F 3d 1061, 1067 (9th Cir 2001)). Thus, the secured creditor can restrict the use of cash collateral by the debtor to pay the debtor's professional fees and expenses, but not the fees and expenses of any statutory or court-appointed committees. Without a source for payment, it is possible that a creditors' committee could be designated and not have the ability to retain its own professionals.

Some professionals have objected, arguing that such restrictions will likely preclude the unsecured creditors from having any professionals willing to work on their behalf. Courts have rejected such arguments. In *In re Hotel Syracuse, Inc* (275 BR 679, 682-83 (Bankr NDNY 2002)) the under-secured creditor, Titan, had consented to a carve-out of up to $200,000 from its cash collateral for the debtor's counsel fees. Attorneys for the official committee for unsecured creditors filed a fee application and Titan objected on the grounds that, among other things, it had not consented to payment of any professional fees other than the debtor's counsel fees. In this case, there was no unencumbered property from which the committee could be paid. The committee argued that such an agreement singles out one administrative claimant to the exclusion of others, allowing the secured creditor to control the outcome of a large Chapter 11 case, and in effect denying certain legal constituencies legal representation. Although the court was somewhat sympathetic to the committee's argument, it ultimately held that the secured creditor had the right to determine how its cash collateral could be used. Other courts have similarly followed suit (eg, see *In re Nuclear Imaging System*, 270 BR 365 (Banker ED Pa 2001) on the objection of trade creditor, secured parties had the right to limit use of cash collateral to pay debtor's counsel fees rather than being paid to the Chapter 7 trustee in bankruptcy for distribution *pro rata* according to the statutory formula).

Strategic use of debtor-in-possession financing by secured creditors

Another source of funding relied upon by debtors is access to credit lines. A debtor or trustee authorised to operate the debtor's business may incur unsecured debt in the ordinary course of business; for example, to buy raw materials, supplies and other goods and services on credit. Other debt, whether unsecured or secured, can be incurred only with bankruptcy court approval. While a debtor has an ability to assume or reject pre-petition executory contracts, debtors are not allowed to assume pre-petition credit agreements and pre-petition lenders cannot be compelled to continue to make advances to a bankrupt company. Thus, prior to or immediately upon commencing a bankruptcy case, the company needs to arrange for new financing agreements in order to obtain working capital to fund operations post-petition (this type of loan is typically referred to as a debtor-in-possession loan). The pre-petition lender often is the post-petition lender of last resort.

Here too secured lenders have imposed significant new requirements to tighten the purse strings. In the past, a debtor-in-possession loan would last for the duration of the bankruptcy case and mature only upon:

- confirmation of a plan of reorganisation;
- conversion of the bankruptcy case to a Chapter 7 liquidation; or
- the appointment of a trustee or examiner or other similar officials.

In recent cases, however, debtor-in-possession lenders have imposed more stringent terms. Thus, it is not uncommon for a debtor-in-possession loan to require that assets be sold within a relatively short period – two months, one year or similar short periods. Debtor-in-possession lenders do not wait until confirmation of a plan in order to be paid. Additional common requirements include:

- higher interest rates;
- commitment fees (which are higher than fees charged outside bankruptcy because of the perceived increased risk);
- covenants regarding the time for filing a reorganisation or liquidation plan and the terms that must be included in such plan; and
- the consent rights of the debtor-in-possession lender to, among other items, the debtor's operating budget, sales of assets and the plan.

Debtor-in-possession loans in aid of an acquisition of the debtor's assets

Recently, private equity firms and hedge funds have gained controlling interests in distressed companies by making loans to financially distressed companies. Subject to certain conditions, at the option of the lender the loans can be converted into newly issued equity upon confirmation of a plan of reorganisation for the financially distressed company. This type of loan, where a lender's investment is ultimately converted into a controlling equity interest, is often referred to as a 'loan to own'.

There are many advantages to employing the loan to own strategy as a means to acquire the debtor or its assets. First, as a debtor-in-possession lender the potential purchaser has a means of controlling the terms of any plan of reorganisation. (The debtor-in-possession loan will typically include a provision that the plan of reorganisation must be in form and substance reasonably acceptable to the debtor-in-possession lender.) In addition, during the bankruptcy the debtor-in-possession lender has access to information regarding the debtor's operations. Most debtor-in-possession lenders require that their consent be obtained before a debtor can sell major assets or assume or reject material contracts. As a result, a party that is interested in acquiring a financially distressed company should consider making a debtor-in-possession loan in order to be involved in key decisions that a debtor may make. These types of decision will likely affect the company's operations after it emerges from bankruptcy.

Certainly, given the current economic downturn there will be many opportunities for parties interested in either a strategic or financial acquisition to acquire the assets of financially distressed companies at a significant discount. Of course, there are many benefits to purchasing assets from a bankrupt company, including the following:

- Buyers can cherrypick the assets they want. The purchaser need not acquire all of the debtor's assets. The purchase agreement will contain schedules of purchased assets and excluded assets.
- The purchase will generally be free and clear of all liens, claims and encumbrances (except any specifically assumed). In this case, any pre-existing liens, claims and encumbrances would attach to the proceeds of sale.
- Third-party consents (other than the consent of the bankruptcy judge) are generally not required, even if the documents say they are. With limited exceptions, anti-assignment clauses, termination clauses and consent provisions are generally not enforceable in bankruptcy.
- Bankruptcy sale provides finality – unsuccessful bidders cannot challenge the terms of the sale (unless they appeal, which is rarely successful).
- The order of the bankruptcy court usually eliminates future litigation risks – the sale cannot be avoided as a fraudulent conveyance.
- There is generally no successor liability.
- The purchaser can cause the debtor to reject or terminate burdensome or unnecessary contracts.

Employing the loan to own strategy is not without some litigation risk, but ultimately bankruptcy courts have approved sales of assets in which the debtor-in-possession lender credit bids amounts owed to it under a debtor-in-possession loan. For example, in *Official Committee of Unsecured Creditors v Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp)*, 353 BR 820, 842 (Bankr D Del 2006)), prior to bankruptcy Radnor obtained a commitment from Tennenbaum Capital Partners LLC, a hedge fund, to purchase $25 million-worth of preferred stock issued by Radnor and to loan Radnor an additional $95 million on a secured basis. As Radnor's financial condition continued to deteriorate, it commenced a Chapter 11 bankruptcy case and entered into an asset purchase agreement and a debtor-in-possession loan agreement with Tennenbaum. Pursuant to the agreements, Tennenbaum was able to consummate the purchase of Radnor's assets by credit bidding amounts owed to it under the debtor-in-possession loan agreement. Radnor's creditors' committee challenged the sale to Tennenbaum, asserting that the loan to own transaction was essentially a sham because Tennenbaum made the loans to Radnor with no expectation of being repaid. That challenge

was rejected by the bankruptcy court. Other recent examples include Zinc Holdings LLC's $5 million debtor-in-possession to bankrupt MTI Technology Corp and a $4 million debtor-in-possession that an Albeco Finance LLC affiliate extended to Corvest Promotional Product Inc.

Deepening insolvency claims potentially threatens secured lenders

One potential consequence of increased control by secured creditors is the risk of potential claims being asserted against them. Several recent cases suggest that lenders may face some risk of liability under a theory of deepening insolvency as a result of the lender's exertion of control over the debtor prior to bankruptcy. For instance, in *Official Comm of Unsecured Creditors v Credit Suisse First Boston (In re Exide Techs, Inc)* (299 BR 732 (Bankr D Del 2003)) and *OHC Liquidation Trust v Credit Suisse First Boston (In re Oakwood Homes Corp)* (340 BR 510 (Bankr D Del 2006)), bankruptcy courts refused to dismiss complaints alleging theories of deepening insolvency based on the lenders' control over and further agreement to lend funds to an insolvent debtor. Despite these decisions, the theory of deepening insolvency is far from universally accepted and it continues to face substantial and mounting criticism, from both courts and commentators alike.

Deepening insolvency has been described as the "fraudulent prolongation of a corporation's life beyond insolvency" that results in damage to the corporation by increased debt. Recent developments in the law of deepening insolvency question whether it is sustainable as an independent tort or whether it is merely a measure of damages, and some courts have even gone as far as to reject the theory outright. Although the majority of cases discussing deepening insolvency have been issued by federal courts, whether deepening insolvency exists, either as an independent tort or as a measure of damages, is ultimately a question of state law. However, with each new explication of the nuances of a theory that is admittedly ill defined, lenders and others can begin to breathe a sigh of relief. After a careful analysis of the development of deepening insolvency as a theory of recovery, several courts have concluded that it cannot be maintained as an independent tort, finding it duplicative of already existing torts such as breach of fiduciary duty. Others have concluded that it requires proof of fraud and cannot be maintained as a mere negligence cause of action.

In the few cases where the theory of deepening insolvency, whether as an independent cause of action or a measure of damages, has been used to allege liability as to lenders, it has been sustainable only on allegations that the lenders had a special or fiduciary relationship with the corporation, usually arising out of control or as an insider of an insolvent debtor, that had been breached. In *Exide*, for example, the lenders, which made an additional loan to the corporation, taking additional guarantees and collateral at a time when the corporation was incurring losses and becoming increasingly insolvent, were alleged to have caused the corporation to acquire a competitor so that the lenders could obtain control, forcing the corporation to "fraudulently continue its business" for almost two years. The Delaware bankruptcy court concluded that Delaware would recognise deepening insolvency as an independent tort and that the complaint sufficiently pled the tort of deepening insolvency, and denied the motion to dismiss. Since that time, however, the Delaware Court of Chancery pronounced its view in *Trenwick v Ernst & Young, LLP* (906 A 2d 168 (Del Ch 2006)) that Delaware would not recognise deepening insolvency as an independent cause of action, concluding that already existing causes of action were sufficient. Of course, the Delaware Supreme Court has yet to address the issue.

Whether framed as a cause of action or a measure of damages, the viability of the concept of deepening insolvency remains uncertain, although there is little doubt that it still has at least some traction in certain courts. What is clear, however, is that merely lending money to an insolvent corporation, without more, is not actionable under the theory of deepening insolvency.

Conclusion

Given the current economic turmoil and tightened liquidity, the restructuring of financially distressed companies presents new challenges. To protect their recoveries, secured creditors are likely to put their troubled borrowers on very short tethers and the cost of a refinancing will be very expensive. On the other hand, given the highly leveraged capital structure, equity holders may determine that it is better for them simply to walk away from a troubled transaction where they are out of the money. Unless secured creditors provide incentives to such equity holders, secured creditors may find themselves holding the keys to many troubled companies.

Although the economic downturn creates challenges, it also presents new opportunities for acquisitions of assets of financially troubled companies. Hedge funds and private equity firms (and strategic buyers) are likely to take advantage of this market to acquire assets at favourable prices. Recognising the advantages of being a creditor in the bankruptcy case, such firms are likely to take advantage of the rights of secured creditors in order to control the process.