

Clarity or Confusion? A Review of Significant Legal Developments in the 2009 Syndicated Loan Market

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2009 was a year of potentially tremendous shifts in the legal landscape for secured creditors. Whether these changes have eroded the protections individual secured creditors have relied on in making their loans or simply recognized and reinforced the ever-present risks faced by secured lenders in the syndicated loan market is a matter of perspective. Taken individually, *Pacific Lumber*, *Philadelphia Newspapers*, *Charter Communications*, *Chrysler*, *Crown Stock*, *TOUSA*, and *Ion Media* represent difficult, and sometimes disastrous, outcomes for secured creditors. Taken together they represent a palpable swing in the legal pendulum away from the expansive rights of individual secured creditors toward the rights and remedies of debtors, unsecured creditors, and in some cases the collective action of a syndicate of lenders. Whether these cases will result in restricting the availability of secured credit and/or increasing the cost thereof remains to be seen.

Perhaps because of an already volatile loan market brought about by the unprecedented financial and economic crisis this past year, these cases have had a relatively immediate and significant impact on the syndicated loan market, both with respect to loan originations and restructurings and workouts. By injecting further uncertainty into the financial markets, the impact of these decisions has affected both pricing (in both primary and secondary markets) and strategy and, therefore, it is critical that lenders be aware of their implications. In *Pacific Lumber* and *Philadelphia Newspapers*, the courts held that a debtor could sell a secured creditor's collateral under a plan without allowing the secured creditor to credit bid its debt.¹ In *Charter Communications*, the court allowed the debtor to reinstate a below-market credit facility notwithstanding substantial alleged covenant breaches.² In *Chrysler*, the court interpreted voting provisions common to many syndicated facilities as giving the requisite majority lenders authority to direct the agent to enforce remedies

over the objection of minority lenders – including consenting to the sale of substantially all their collateral free and clear of liens and credit bidding all of the lenders' debt.³ In *Crown Stock* and *TOUSA*, the courts ruled that a seller financed LBO and a syndicated secured financing, respectively, were fraudulent transfers and imposed draconian remedies on the parties.⁴ In *Ion Media*, the court strictly construed an intercreditor agreement in favor of the senior lenders, denying the junior lenders' standing to use the bankruptcy process to circumvent the subordination provisions set forth in the Intercreditor Agreement.⁵ This article will explore the significance of each of these important legal developments with a specific focus on the implications of these developments on the syndicated loan market.

NO RIGHT TO CREDIT BID

Within two months, both the Fifth Circuit in *Pacific Lumber* and a District Court in the Eastern District of Pennsylvania in *Philadelphia Newspapers* (reversing the Bankruptcy Court) held that secured creditors do not have the right to credit bid on the sale of their collateral if their borrowers employ the "indubitable equivalence" prong of the bankruptcy cram down provisions in section 1129 of the Bankruptcy Code, as an alternative to the more conventional cram down through a deferred payment note or plan sale.⁶ Accordingly, both cases held that section 1129(b)(2)(A)(iii) of the Bankruptcy Code can be used to deny secured creditors the ability to credit bid their debt, a basic enforcement

3 *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), cert. dismissed, 130 S. Ct. 41, 174 L. Ed. 2d 625 (2009).

4 *Boyer v. Crown Stock Distrib., Inc.*, 587 F.3d 787 (7th Cir. 2009); *Official Comm. of Unsecured Creditors of TOUSA, Inc., et al. v. Citicorp North America, Inc., et al. (In re TOUSA, Inc.)*, No. 08-10928-JKO, 2009 Bankr. LEXIS 3311 (Bankr. S.D. Fl. Oct. 13, 2009), appeals docketed, Nos. 10-cv-60017, 10-cv-60018 and 10-cv-60019 (S.D. Fl. Jan. 5, 2010).

5 *In re ION Media Networks, Inc.*, No. 09-13125 (JMP), 2009 Bankr. LEXIS 3710 (Bankr. S.D.N.Y. Nov. 24, 2009), appeal docketed, No. 09-10596 (S.D.N.Y. Dec. 30, 2009).

6 The Loan Syndication and Trading Association filed a friend of the court brief (amicus brief) on November 20, 2009, with the Third Circuit Court of Appeals, arguing against the District Court's interpretation of section 1129 of the Bankruptcy Code. See *In re Phila. Newspapers, LLC*, Nos. 09-4266 and 09-4349 (3d Cir. Nov. 12, 2009).

1 *In re Pacific Lumber Co*, 584 F.3d 229 (5th Cir. 2009); *In re Phila Newspapers, LLC*, Civ. Action. No. 09-mc-00178, 2009 U.S. LEXIS 104706 (E.D. Penn. Nov. 10, 2009), appeals docketed, Nos. 09-4266 and 09-4349 (3d Cir. Nov. 12, 2009).

2 *In re Charter Communc'ns, LLC*, No. 09-11435 (JMP), 2009 Bankr. LEXIS 3609 (Bankr. S.D.N.Y. Nov. 17, 2009), appeal docketed, No. 09-10328.

remedy that secured lenders had previously viewed as a fundamental, bargained-for right.

Assuming that the requirements of the Bankruptcy Code are otherwise satisfied, including the absolute priority rule,⁷ section 1129(b)(2)(A) allows a plan to be “crammed down” over the objection of a secured creditor if the plan is “fair and equitable” and further provides for one of three alternatives: (i) the secured creditor’s retention of its liens and receipt of payments over time equal to the amount of the secured claim on a net present value basis and equal, in the aggregate, to the total allowed claim; (ii) the sale of the collateral free and clear of liens if the creditor’s liens attach to the proceeds and the creditor is given the right to credit bid; or (iii) the realization by the secured creditor of the “indubitable equivalent” of its secured claim. Both courts interpreted section 1129(b)(2)(A)(iii) according to what they characterized as its “plain” or literal meaning, concluding that it provides an alternative to cram down a secured creditor’s claim without giving such creditor the ability to credit bid under section 1129(b)(2)(A)(ii) so long as the secured creditor receives the “indubitable equivalent” of its claim. The term “indubitable equivalent” is not defined in the Bankruptcy Code, leading both courts to interpret it as a flexible and permissive alternative for cramming down a secured creditor. Included in this flexible alternative is the ability to pay the secured creditor the present value of its secured claim based on either a judicial determination of the value of the collateral derived from expert testimony (*Pacific Lumber*) or the sale of the collateral at auction (even to a stalking horse bidder affiliated with the debtor), with the “market value” defined as the ultimate sale price even if the secured creditors are prohibited from credit bidding at the auction (*Philadelphia Newspapers*).

PACIFIC LUMBER

Pacific Lumber Company and Scotia Pacific LLC were two of six affiliated debtors that grew, harvested and processed redwood timber in Humboldt County, California. Pacific Lumber owned Scotia Pacific and owned and operated a sawmill and the company lumber town of Scotia, California. In 1998, Pacific Lumber sold 200,000 acres of prime redwood timberland to Scotia Pacific, a bankruptcy remote special purpose entity, as part of the sale of \$867.2 million in notes secured by the timberlands. These secured notes formed the basis of the Noteholders’ secured claims that were ultimately prohibited from credit bidding at the private

sale of the assets of Pacific Lumber and Scotia Pacific to the plan proponents, Mendocino Redwood Company (a competitor) and Marathon Structured Finance (a prepetition and DIP lender).

Several competing plans were filed, but the defining feature of the only plan the court found confirmable was Mendocino’s and Marathon’s contribution of \$580 million to a new entity for use to purchase the timberlands from Scotia Pacific. Under the plan, the court would then set the value of the timberlands (ultimately set at \$510 million) and that amount would be paid to the Noteholders as the “indubitable equivalent” of their collateral.

The Fifth Circuit focused on three questions in its analysis of section 1129(b)(2)(A)(iii) – first, is clause (iii) an alternative or stand alone method of cram down or should it be read to include a requirement that plan sales must include a right to credit bid; second, what does “indubitable equivalent” mean; and third, if “indubitable equivalent” can mean the receipt of money equal to the amount of the secured claim, then how is the amount of the secured claim determined? Focusing on the so-called “plain meaning” of the statute the court held that clauses (i), (ii) and (iii) of section 1129(b)(2)(A) are each independent and alternative grounds for establishing that a plan is “fair and equitable” for purposes of cramming down a secured creditor’s claim. The court then defined “indubitable equivalent” to mean a treatment that protects what is “really at stake in secured credit: repayment of principal and the time value of money.” *Pacific Lumber*, 584 F.3d at 247. Reasoning that the most a secured creditor can expect as a return on its secured claim is to realize the value of its collateral at any given point in time, the court concluded that the payment of money equal to the value of that collateral must be the indubitable equivalent of the lien because it ensures repayment of the secured portion of the principal and avoids any need to account for the time value of money. This conclusion begs the court’s third question, namely how to accurately value the collateral so that the secured creditor can recover the indubitable equivalent of its liens.⁸

Secured creditors are commonly very skeptical of judicial determinations of value, and rightfully so. Having a court set the hypothetical value of an asset based on the testimony of “dueling experts” can often be the antithesis of actual market value, i.e. the price established by a willing buyer and a willing seller. Therefore, the ability to credit bid imposes a necessary check on a

7 The absolute priority rule provides that, unless the creditor consents, a plan cannot distribute any value to a junior class of creditors unless and until all senior classes receive value equal to the full amount of their allowed claims. See 7 Lawrence P. King et al., *Collier on Bankruptcy* P 1129.04[4][a], at 1192-93 (15th ed. rev. 2008).

8 Neither the *Pacific Lumber* court nor the *Philadelphia* Court delved into the complicated question of how the collateral should be valued, i.e. on a liquidation basis or as a going concern. Implicitly both courts valued the collateral at the value the prospective buyers were willing to pay which was essentially the going concern value.

judicial determination of value that the secured creditor believes is too low and not what it would be willing to accept as the “value” of its collateral or the “indubitable equivalent” of its claim.⁹ Absent the fundamental right to credit bid, the secured creditor can be stripped of its core right to implement that “check” – i.e., test a judicial determination of the value of its collateral by participating in the auction with a credit bid of its debt.

PHILADELPHIA NEWSPAPERS

Philadelphia Newspapers and its affiliated debtors own and operate numerous print and online publications in the Philadelphia region. The publications were sold to a Philadelphia based investor group for \$515 million in 2006. To finance the acquisition the investor group borrowed \$295 million, secured by substantially all of the newspaper’s assets. The debtors sought to reorganize by selling their assets to another Philadelphia based investor group. Ultimately, the debtors selected Philly Papers, LLC, an investment group with significant overlapping ownership interests to be the stalking horse bidder for the debtors’ assets. The debtors also proposed bid procedures that prevented the secured lenders from credit bidding. The stalking horse bid included a \$30 million cash purchase price and the assumption of certain obligations valued at an additional \$11 million. The bulk of the proceeds were to be used to pay administrative costs and the DIP loan. The remainder, plus any overbids, would be paid to the secured lenders. If the stalking horse bid is the successful bid,

then as of the date of the District Court’s opinion the secured lenders would be expected to receive a \$6 million recovery and the return of real property valued at approximately \$30 million.¹⁰

The Bankruptcy Court rejected the proposed bid procedures and required that the secured creditors be given the ability to credit bid their debt. The debtors appealed.¹¹ The District Court, sitting as an appellate court, reversed and held that section 1129(b)(2)(A)(iii) provides an alternative cram down route that does not require the secured creditor be given a chance to credit bid.¹²

Like the court in *Pacific Lumber*, the District Court in *Philadelphia Newspapers* focused its analysis on the plain meaning of section 1129. It concluded that the three prongs of section 1129(b)(2)(A) are disjunctive alternatives for cramming down a secured creditor. To define “indubitable equivalent” the court focused on a famous opinion from 1935 where Judge Learned Hand coined the term “indubitable equivalence.” Judge Hand wrote:

a creditor who fears the safety of his principal will scarcely be content with . . . [interest payments alone]; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that . . . unless by a substitute of the most indubitable equivalence.

In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935) (emphasis added). The District Court held that section 1129(b)(2)(A)(iii) only requires that the secured creditor receive an equivalent substitute for the return of its money or its property. It then concluded that Congress, by using such a vague term, has provided “an invitation to debtors to craft an appropriate” and flexible treatment of secured claims. *Phila. Newspapers*, 2009 U.S. Dist. LEXIS 104706, at * 49.

In recognition of the insider nature of the transaction and the other concerns raised by the Bankruptcy Court regarding the bid

9 There are many strategic reasons a debtor might seek to block a secured creditor’s ability to credit bid. Justifications include efforts to subvert a secured creditor’s leverage or to prefer a buyer or transaction that benefits unsecured creditors or management (through the assumption of claims by the buyer or the agreement that the buyer will operate the business as a going concern which can benefit trade creditors and existing management). Moreover, a common business justification is that the potential for a large credit bid “chills” the bidding because potentially interested parties are unwilling to do the diligence and undertake the substantial effort to bid on the assets if they fear the secured lender can prevail at the auction without any cash consideration. The contrary view recognizes that the potential for a credit bid promotes a more competitive process by assuring that parties with the greatest incentive to maximize the value of the collateral are able to participate in the auction. The fear that credit bids “chill” bidding can be multiplied if the debtors and potential bidders believe that the secured debt was acquired at a substantial discount by parties intent on acquiring the collateral. Partially in an attempt to address the fear that the secured creditors’ traditional right to credit bid may be acquired in an attempt to manipulate an auction there has been a recent resurgence in attempts to compel creditors to make Bankruptcy Rule 2019 disclosures if creditors form an ad hoc group that seeks to participate in the bankruptcy process. Bankruptcy Rule 2019 disclosures include the requirement that the creditors disclose the economics of their trades. See *In re Wash. Mut., Inc.*, No. 08-12229 (MFW), 2009 Bankr. LEXIS 3836 (Bankr. D. Del. Dec. 2, 2009) (requiring group of noteholders to file Rule 2019 disclosures and suggesting that they may have fiduciary duties to other similarly situated creditors); *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (requiring group of shareholders to file Rule 2019 disclosures). - ; but see *In re Premier International Holdings, Inc., et. al. (Six Flags Operations)*, No. 09-12019 (CSS), Docket No. 1378 (Bankr. D. Del. Jan. 11, 2010) (denying motion to compel group of noteholders to file Rule 2019 disclosures). Although beyond the scope of this Article, the trend to force Rule 2019 disclosure of the economic terms of secondary trading should be of significant concern to the syndicated loan market

10 Unfortunately, the increased administrative claims the debtors will incur during the pendency of the appeals can be expected to reduce the proceeds available to the secured creditors if the sale to the stalking horse bidder is consummated.

11 Among other reasons for requiring that the bid procedures allow the secured lenders to credit bid, the Bankruptcy Court found that the overlap between the current equity owners and the equity owners of the stalking horse bidder rendered “the proposed sale to the Stalking Horse Bidder an insider transaction. As such, it warrants close scrutiny.” *In re Phila. Newspapers, LLC*, 2009 Bankr. LEXIS 3167, at *28 (Bankr. E.D. Pa., Oct. 8, 2009), *rev’d Phila. Newspapers*, 2009 U.S. Dist. LEXIS 104706 (Bankr. E.D. Pa., Nov. 10, 2009). The Bankruptcy Court also concluded that there was no business justification, other than attempting to ensure that the stalking horse bidder was the successful bidder, for preventing the secured creditors from credit bidding. *Id.* at *29.

12 *Philadelphia Newspapers* is now on appeal to the United States Court of Appeals for the Third Circuit. The Third Circuit stayed the auction pending resolution of the appeal. It heard oral argument on December 15, 2009. A decision is expected shortly.

procedures and the shortcomings of the debtors' business rational, the District Court limited its ruling to the narrow question of whether, under section 1129(b)(2)(A)(iii), a plan was required to permit the secured creditor to credit bid in a sale of its collateral.¹³ The court held that there was no credit bid requirement – all that is required is for the secured creditor to receive the “indubitable equivalent” of its claim in whatever “flexible” form it should take.

IMPLICATIONS OF PACIFIC LUMBER AND PHILADELPHIA NEWSPAPERS

Prior to *Pacific Lumber* and *Philadelphia Newspapers*, plans of reorganization generally attempted to cram down the claims of secured creditors by either “stretching” out repayment of such claims pursuant to deferred payments under a new note under section 1129(b)(2)(A)(i) or by selling their collateral subject to credit bid rights under section 1129(b)(2)(A)(ii). Section 1129(b)(2)(A)(iii) – the indubitable equivalent provision – was rarely invoked.¹⁴ Both the *Pacific Lumber* and *Philadelphia Newspapers* courts have now shifted this paradigm by allowing debtors to use various valuation methodologies – whether it be dueling valuation experts or an auction that might be conducted under less than ideal circumstances and preclude credit bidding by the secured party – to provide the basis for determining that a secured creditor has in fact received the “indubitable equivalent” of its secured claim over the creditor's objection.¹⁵

Based on these rulings, secured creditors may expect a surge in “indubitable equivalence” plans in situations where debtors are seeking increased leverage to resolve their bankruptcies through asset sales or new value plans, as opposed to more traditional reorganizations. Unlike 363 sales in which the secured creditor has a statutory right to credit bid or 1129(b)(2)(A)(ii) cram down plans contemplating a sale of assets, “indubitable equivalence” plans provide the debtor the opportunity to restructure over the objections of secured creditors by paying the secured creditors less than the value that the secured creditors might place on their own collateral. Whether the cash payment is actually the

“indubitable equivalent” of the secured claim could unfortunately turn on a third party's valuation of the collateral and for better or for worse, the “value” of a distressed asset is inherently difficult to determine and subject to a myriad of intentional and inadvertent manipulations.

OLD DEBT IS NEW AGAIN

In *Charter Communications*, pursuant to a prepackaged plan of reorganization, the debtors successfully eliminated \$8 billion of bond debt while simultaneously preserving \$11.8 billion of senior secured debt over the strenuous objections of its senior secured lenders. The *Charter Communications* plan was premised on deleveraging the cable company by converting its bonds to equity, raising \$1.6 billion from a rights offering and reinstating \$11.8 billion of substantially below market and covenant-light unmatured debt. This ambitious plan would only be possible if the debtors could strip Paul Allen, the co-founder of Microsoft and the majority equity holder, of his equity control without triggering a change in control event of default in the senior financing or destroying \$2.8 billion in net operating losses.

The debtors succeeded. In what the court described as a monumental “gamble”, the carefully planned and executed strategy of Charter Communications resulted in a deleveraging of the company, realization of hundreds of millions of dollars of interest savings per year on the reinstated senior facility, preservation of net operating losses and entry into a settlement with Paul Allen where he received \$375 million in value in exchange for retaining a minimum voting percentage of 35% and the ability to appoint four out of eleven board members. The senior lenders and others are currently appealing the Bankruptcy Court's confirmation order, but no stay pending appeal was granted and Charter Communication's plan has now gone effective, potentially mooting many aspects of the appeal.

The senior lenders vigorously opposed the reinstatement of the \$11.8 billion of senior secured debt and attempted to force the debtors to refinance the obligations with new debt at market rates or to substantially increase the interest rate and strengthen the covenants of the existing debt to reflect current market conditions. The debtors, on the other hand, viewed the senior facility as a valuable asset and therefore structured their pre-negotiated plan and the limited defaults under the senior facility with the paramount goal of preserving the senior secured debt at its existing terms.

Section 1124(2) of the Bankruptcy Code authorizes a debtor

¹³ The District Court specifically declined to find that the plan was fair and reasonable or otherwise confirmable.

¹⁴ See *Pacific Lumber*, 584 F.3d at 246 (“What measures constitute the indubitable equivalent of the value of the Noteholders' collateral are rarely explained in caselaw, because most contested reorganization plans follow familiar paths outlined in [section 1129(b)(2)(A)] (i) and (ii).”)

¹⁵ By permitting secured creditors to be crammed down through the indubitable equivalent prong of section 1129(b)(2)(A) courts are also stripping secured creditors of the ability to make the section 1111(b) election to have the full amount of their claim encumber their collateral after the effective date of the plan even if they are given a note with a lower face amount as part of the cram down. See *In re Phila. Newspapers, LLC*, Nos. 09-4266 and 09-4349, LSTA Amicus Brief (3d Cir., Nov. 12, 2009).

to reinstate and deaccelerate prepetition debt if it: (1) cures all prepetition defaults other than *ipso facto* defaults,¹⁶ (2) reinstates the pre-default maturity of the debt, (3) satisfies any damages incurred in reliance on the credit agreement or applicable law, (4) compensates the lender for any losses incurred due to nonmonetary default, and (5) does not otherwise alter the legal, equitable, or contractual rights of the lender. The underlying rationales for section 1124(2) and the ability to cure and reinstate is that a creditor cannot receive better rights as a result of bankruptcy than their prepetition bargain¹⁷ and that by reinstating the original debt, the creditor will receive the full benefit of its original bargain and should consider itself “fortunate indeed [with] no cause to complain.”¹⁸

The senior lenders objected to reinstatement of the debt on three grounds. First, they argued that Charter Communications Operating, LLC, the borrower and main operating company, misrepresented the prospective ability of its parent companies to pay their debts as they came due when it made a \$250 million draw on the senior credit facility. The senior lenders argued that this amounted to a historical default that could not be cured, precluding reinstatement. Second, the lenders asserted that extinguishing Paul Allen’s equity interest and the acquisition of new equity by a “group” of bondholders resulted in a change of control event of default. Third, they argued that certain holding companies’ failure to pay principal and interest on their bond indebtedness resulted in a cross-default of the senior facility.

The Bankruptcy Court rejected all three of these arguments. On the first argument, the court found that there was no prepetition misrepresentation of the holding companies’ prospective ability to pay their debts because the clause in the credit agreement had no prospective application.¹⁹ The court ruled that the two parent companies were solvent and able to pay their debts when the draw request was made and that the subject financial covenant was too vague to be read to impose a forward-looking duty on the company to certify the future solvency of the entities, a somewhat ironic conclusion given that the parent companies were

literally on the brink of insolvency, and a result that was clearly not what the secured lenders had intended. As part of the court’s reasoning, it made the simple observation that none of the representatives of the lenders could definitively describe how forward looking the solvency representation was intended to be. Views ranged from “unsure” and “no specific period of time” to 4-5 quarters or 6-12 months. *Charter Communc’ns.*, 2009 Bankr. LEXIS 3609, at *51.

The court further ruled that the plan did not effect a change in control and therefore there was no related event of default. The court held that neither Paul Allen’s loss of his economic interest in the company nor the bondholder “group’s” new equity interest was a change in control. The court noted that the change in control provisions had been periodically revised to be less and less restrictive, including the current wording of the clause, which required Paul Allen to hold at least 35% of the voting power but did not require him to retain any ongoing economic interest. The court held that the Paul Allen settlement, where he retained the requisite voting rights, was sufficient to avoid a change in control. As for the “group” of bondholders, the credit agreement prevented a “group” as defined in 13(d) of the Securities Exchange Act of 1934 from acquiring 35% of the voting rights. The court found there was no express or implied agreement between the major bondholders regarding their interests in Charter Communications and therefore they were not a “group” for securities law purposes even though they were acting in concert for common economic motivations.

The court also rejected the argument that the parent companies’ defaults on their bond obligations should trigger incurable cross-defaults on the senior facilities. The court viewed the cross-default clause with suspicion and ruled that because the companies were part of an “integrated enterprise, and the financial condition of one affiliate affects the others” that the clause not only related to the financial condition of the holding companies but the financial condition of the borrower and thus the cross-default is an *ipso facto* default that does not need to be cured for the debt to be reinstated. *Id.* at *67.

In the end, the Bankruptcy Court confirmed Charter Communication’s plan and allowed it to deleverage itself while reinstating \$11.8 billion of admittedly below-market financing. The debtors were able to cure and reinstate the senior debt and thereby sidestep the secured lenders’ customarily formidable bankruptcy leverage following an event of default. By reinstating the debt, the debtors were also able to structure a plan that did not make

16 Examples of *ipso facto* defaults includes defaults based on the insolvency or financial condition of the debtor, commencement of a bankruptcy case, the appointment of a trustee, or the failure to pay default rates or penalties resulting from nonmonetary breaches.

17 See *Butner v. United States*, 440 U.S. 48 (1979).

18 See *In re Gillette Assocs., Ltd.*, 101 B.R. 866, 875 (Bankr. N.D. Ohio 1989); and *S. Rep. 95-598*, at 120 (1978).

19 The clause at issue read, it shall be an event of default if any of the holding companies “shall generally not, or shall be unable to, or shall admit in writing its inability to, pay its debts as they become due.”

any economic concessions to their senior creditors and instead held them to their pre-bankruptcy bargain, notwithstanding the substantial changes in intervening events for both Charter Communications and the financial markets in general. In an area where there is very little established case law, the *Charter Communications* decision should put senior lenders on high alert in those cases where a borrower has a below-market loan, is not in payment default, and has the liquidity to both operate and fight valuation in order to argue that the senior debt is fully secured (in a general economic climate where bankruptcy courts are loathe to value companies in the trough) and thereby provide equity value to subordinate creditors in the capital structure, such as unsecured creditors or bondholders.²⁰

MAJORITY RULES - COLLECTIVE ACTION

The increase in syndicated loans since the last recession, coupled with the wave of bankruptcy filings this recession, has presented courts with their first opportunity to rule on the complicated issues of what enforcement rights a syndicate of lenders can direct the agent to exercise through the requisite majority provided in their loan documents (customarily a majority) and what actions require unanimous consent, giving each lender a potential veto right. Each of the courts that examined these issues, with the most notable example being the Second Circuit in *Chrysler*, has concluded that, as a general proposition, the collective action provisions in credit agreements should be read expansively to authorize an agent or collateral trustee to act on behalf of lenders and any provision requiring a unanimous vote should be read narrowly.²¹ Specifically, in the case of release of liens (both with respect to a Section 363 sale to a third party and a credit bid scenario), these recent cases have held that the requisite majority of lenders may direct the agent to take enforcement action pursuant to the collateral security agreement. The typical security agreement only requires a numerical majority of lenders to authorize the exercise of remedies (including releasing liens) instead of the unanimous lender consent required to take other actions such as consensually releasing liens on substantially all

of the collateral. Accordingly, these rulings further the ability of syndicates to act by requisite majority and thereby prevent minority lenders from exercising blocking positions with respect to exit strategies in a distressed scenario, even if the restructuring has the effect of releasing liens on substantially all of the lenders' collateral.

In *Chrysler*, the court examined whether the agent on behalf of the requisite lenders could direct the collateral trustee to consent to the sale of all of its collateral – namely all of Chrysler's assets – free and clear of liens under section 363(f) of the Bankruptcy Code. The court concluded that the agent and collateral trustee were authorized to consent to the sale free and clear in accordance with the various collateral security and loan documents. The court acknowledged that the two types of loan provisions at issue are clauses that allow the agent to enforce remedies and protect, preserve and realize on the collateral at the direction of requisite lenders and clauses that require unanimous consent to amend loan documents or release liens on substantially all of the collateral in fully consensual transaction. The *Chrysler* court held that the collateral trustee had the “power to take any action necessary to realize on the collateral – including giving consent to the sale of the collateral free and clear of all interests under § 363.” *Chrysler*, 576 F.3d at 120. The court continued, “[b]ecause the Sale required no amendment to the loan documents, Chrysler was not required to seek, let alone receive, the [minority lenders'] written consent.” *Id.*²²

22 The *Chrysler* opinion addressed a broad range of controversial issues, including (1) whether an expedited section 363 sale can be used to sell substantially all of a company's assets when there is an appropriate business justification, (2) whether it is permissible to structure a sale to deliver value to unsecured creditors before secured creditors are paid in full, and (3) when is a section 363 sale in effect an impermissible plan of reorganization. On June 5, 2009, the Second Circuit issued a short ruling affirming the Bankruptcy Court's sale order. On June 8, 2009, shortly before the sale was scheduled to close, the United States Supreme Court issued a stay of the sale pending appeal. On June 9, 2009, the Supreme Court vacated its stay and allowed the sale to close. Then, on August 5, 2009, well after the sale closed, the Second Circuit issued its detailed written opinion affirming the sale order. On December 14, 2009, in a surprise decision, the Supreme Court issued a four sentence order accepting the appeal (granting the writ of certiorari), vacating the Second Circuit's decision and remanding the appeal to the Second Circuit to be dismissed. See *Ind. State Police Pension Trust v. Chrysler LLC*, 2009 U.S. LEXIS 9112 (U.S. Dec. 14, 2009). In its short ruling, the Supreme Court cited to *United States v. Munsingwear, Inc.*, 340 U.S. 36 (1950) a case in which the Supreme Court vacated an appellate court's ruling on the grounds that it was moot, noting that rulings should be vacated “in precisely this situation to prevent a judgment, unreviewable because of mootness, from spawning any legal consequences.” *Munsingwear*, 340 U.S. at 42. The Supreme Court's terse order destroyed the precedential effect of the Second Circuit's *Chrysler* opinion. However, by not explaining the reasoning behind the decision to vacate the ruling, other than that the case was moot, it is unclear what aspects of the opinion the Supreme Court found problematic. Given that the collective action portions of the opinion represented only a narrow element of a very controversial opinion and that the issues on appeal to the Supreme Court focused on whether the 363 sale was proper, the Second Circuit's arguments supporting collective action by secured lenders may still be persuasive to other courts.

20 *In re Spectrum Brands Inc.*, No. 09-50456 (Bankr. W.D. Tex., Sept. 30, 2009) also involved an attempt to reinstate the secured creditors' debt. The parties in *Spectrum* ultimately reached a consensual resolution of the attempt to reinstate the debt and so no legal precedent on the issue resulted from the case.

21 Examples of recent cases on this issue are: *Chrysler*, 576 F.3d 108 (majority of lenders can direct the agent to consent to a sale free and clear of liens); *In re Metaldyne Corp.*, 409 B.R. 671 (Bankr. S.D.N.Y. 2009) (allowing the agent to credit bid all of the debt on the instructions of a majority of lenders and over the opposition of a minority); *In re GWLS Holdings, Inc.*, No. 08-12430, 2009 Bankr. LEXIS 378 (Bankr. D. Del. Feb. 23, 2009) (same); *In re Electroglas Inc.*, No. 09-12416 (PJM), Ruling on Credit Bids [Doc. No. 263] (Bankr. D. Del. Sept. 23, 2009) (allowing agent to credit bid at the direction of lenders but precluding either majority or minority lenders from credit bidding in their own right).

In *Metaldyne*, a Bankruptcy Court in the Southern District of New York ruled that the agent, on behalf of the requisite lenders, was authorized to credit bid the entirety of the debt over the objection of a minority lender.²³ In *Metaldyne*, 97% of the senior lenders agreed to form a consortium to credit bid for their borrower's assets. After an extensive auction, the lender consortium was declared the prevailing bidder. Its bid package consisted of \$39.5 million in cash, assumption of \$8.5 million in administrative priority claims, \$2.5 million to fund a litigation trust, assumption of a \$15 million note, the credit bid of \$425 million of debt and the release of liens on all assets not included in the sale.

The dissenting lenders in *Metaldyne* focused on voting provisions very similar to those addressed by the court in *Chrysler*, namely the requirement that any waiver, amendment or modification of the credit agreement that releases all or substantially all of the collateral requires the written consent of all lenders. The debtors and majority lenders instead relied on the "irrevocable" appointment of the administrative agent as the agent for the lenders and the authorization of the agent "to take such actions on [each lender's] behalf and to exercise such powers as are delegated to the [agent] by the terms of the Loan Documents, together with such actions and powers as are reasonably incidental thereto." In addition, the agent may "exercise any and all rights afforded to a secured party under the Uniform Commercial Code or other applicable law. . . . the [Agent] shall have the right . . . to sell or otherwise dispose of all or any part of the Collateral . . . for cash, upon credit or future delivery as the [Agent] shall deem appropriate." *Metaldyne*, 409 B.R. at 676. Like the *Chrysler* court, the *Metaldyne* court relied on the broad grant of enforcement rights to the agent and the fact that consenting to the sale and credit bidding the debt did not require any amendment to the loan documents to conclude that (i) the agent was authorized to act on behalf of the lenders and (ii) the minority lenders had no ability to prevent the action. It should be noted, however, that while the court in *Metaldyne* approved the agent's credit bid, it explicitly did not allow the sale order to grant the agent or the lenders any releases or immunize them of their duties to the minority lenders. The court concluded that should the minority lender have any rights under the loan documents, including the right to demand a pro rata distribution of any recovery, those rights would be preserved. *Id.* at 680.

Whether this line of cases represents a positive development will

most likely turn on whether a syndicate member finds itself in the majority or minority on a particular enforcement issue. That said, by strengthening the ability of syndicates to take collective action, courts are undeniably enhancing the ability of debtors to reorganize or liquidate through the sale of assets by preventing minority lenders from standing in the way of action that the majority determines to be in the best interest of the credit. There is also the potential that this rationale could be taken to its logical extreme, with an agent arguing that it has been delegated the right to vote the entire class of claims under a plan at the direction of the requisite majority under the theory that such action is nothing more than enforcement of remedies. At a minimum, in future deals (both originations and workouts), watch for increased focus in the collateral security documents on negotiating specific voting requirements for significant enforcement actions.

LENDER LIABILITY REDUX

A recent crop of cases now places secured creditors squarely in the crosshairs of fraudulent transfer claims as debtors, creditors committees and trustees scramble to preserve value for significantly out-of-the-money unsecured creditors. It is perhaps not without coincidence that this new lender liability threat comes on the heel of the relative demise of traditional deepening insolvency claims, especially in the Third Circuit, as unsecured creditors scramble for leverage. While secured lenders have historically been exposed to threats of equitable subordination and fraudulent transfer liability by other stakeholders, these claims now have real teeth in light of the recent *Crown Stock* and *TOUSA* decisions, among others.²⁴

In *Crown Stock*, Judge Posner, a leading judge on the Seventh Circuit Court of Appeals and a noted legal economist, held the seller shareholders in an LBO liable for a fraudulent transfer when the LBO debt left the company with unreasonably small capital. The court held that an LBO leaves the debtor with unreasonably small capital when "on the day the LBO is consummated [the debtor has] at that moment such meager assets that bankruptcy is a consequence both likely and foreseeable." *Crown Stock*, 587 F.3d 787, at *15. The court held that the debtor commenced its existence with almost no net assets because all of its assets were encumbered by acquisition debt and its cash resources were drained by a presale dividend and its extensive interest obligations to fund the acquisition. The court continued,

23 The District Court affirmed the sale on December 29, 2009, finding that the lender group was a good faith purchaser and that the appeal of the unstayed sale order was moot. See *In re Metaldyne*, 09 Civ. 7897(DLC) (S.D.N.Y. Dec. 29, 2009).

24 Although vacated by the court after the parties reached a settlement, a Bankruptcy Court in the District of Montana subordinated the claims of the secured lenders to all unsecured claims in *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club LLC)*, No. 08-61570 (Bankr. D. Mont. May 12, 2009).

the debtor “was naked to any financial storms that might assail it. So the statutory conditions for a fraudulent conveyance were satisfied.” *Id.* at *17. Judge Posner then considered the question of damages. The court held that the shareholders in an LBO are “initial transferees” and therefore not entitled to any good faith defenses and that even if they were second-stage transferees they “gave no ‘value’ in the transfer and so are not protected by section 550(b).” *Id.* at *22. The court continued “our reclassification of the sale of assets as an LBO unravels the sale, because the ostensible buyer paid nothing (well, \$500), having bought the company with the company’s own assets. Because the sale is to be ignored, any money received from the sale of the company’s assets that is not wed to a creditor belongs to the original shareholders.” *Id.* at *26. The court then affirmed the judgment of the Bankruptcy Court ordering disgorgement of the sale proceeds from the shareholders, added the disgorgement of the presale dividend, and then noted that, to the extent all of the debtor’s creditors and administrative claimants were satisfied, any remaining funds would be returned to the defendants in their capacity as shareholders.

Although the facts in *Crown Stock* are somewhat idiosyncratic, the rationale will no doubt be wielded against more sophisticated and high value LBOs given the prominence of the Seventh Circuit and Judge Posner. The LBO in *Crown Stock* involved a closely held company, Old Crown, distributing all of its cash to its shareholders and then selling its assets to another company, New Crown, with essentially the same name in exchange for a \$6 million purchase price funded through a \$3.1 million bank loan and a \$2.9 million promissory note. After the sale, Old Crown distributed the \$3.1 million in cash proceeds to its shareholders and similarly distributed the payments on the promissory note when received. New Crown survived for three and a half years but ultimately filed for bankruptcy with \$1.7 million of unsecured claims in addition to the secured debt. Although the Bankruptcy Court did not collapse the sale transaction and the presale dividend into one transaction, the Seventh Circuit rejected this conclusion and ignored the form of the transaction – a dividend and asset sale – and held that its substance – a shareholder sale – should govern and that the cumulative transaction was a fraudulent transfer.

In *TOUSA*, the Bankruptcy Court issued a far-reaching ruling resulting in the avoidance of liens and claims and the disgorgement of hundreds of millions of dollars by both the secured lenders and the recipients of a settlement payment financed by the secured lenders. The *TOUSA* opinion is currently on appeal. At issue was a \$500 million secured loan made by a syndicate

of lenders to *TOUSA* and its subsidiaries six months prior to *TOUSA*’s bankruptcy. The loan was secured by substantially all of *TOUSA*’s and its subsidiaries’ assets. The express purpose of the loan was to finance the payment of a \$421 million judgment against *TOUSA*, Inc., and its subsidiary *TOUSA Homes*, Inc., in favor of a group of lenders related to a failed business venture.

The court ruled that *TOUSA*’s subsidiaries, other than *TOUSA Homes*, were not obligated on the \$421 million judgment and therefore did not receive any value (let alone reasonably equivalent value) in exchange for encumbering their assets or transferring their interest in the new loan proceeds to the judgment creditors. The court also held that the loans either rendered *TOUSA* and its subsidiaries insolvent or left them with unreasonably small capital in light of the rapidly declining housing market. The Bankruptcy Court concluded that the new loan and the payment of the judgment creditors involved three avoidable “constructively fraudulent” transfers: (1) the subsidiaries’ grant of liens to secure the new \$500 financing, (2) the subsidiaries’ transfer of their share of the \$500 million in loan proceeds to *TOUSA* and the judgment creditors, and (3) the transfer by *TOUSA* and *TOUSA Homes* of the loan proceeds to the judgment creditors to satisfy their unsecured judgment.

The secured lenders asserted the defense that they were “good faith” transferees entitled to the liens and interests they received under section 548(c) of the Bankruptcy Code. The court rejected this rationale and held that the lenders had “sufficient knowledge to place [them] on inquiry notice of the debtor’s possible insolvency,” thereby creating a due diligence obligation on lenders extending loans.²⁵ The court noted that, in response to a letter to *TOUSA*’s board from counsel for one of the bondholders that warned that the loan would render *TOUSA* unable to pay its debts as they became due, secured lenders required *TOUSA* to provide the lenders with a solvency opinion. The court found the conclusions in the solvency opinion highly suspect and disregarded them for several reasons, most notably because the opinion relied on untested and outdated financial assumptions provided by *TOUSA* that did not account for the precipitous declines in the housing market, and because the provider of the opinion was working on a contingency basis where it would receive \$2 million if it opined that *TOUSA* was solvent, but would only receive its hourly fees and costs if it concluded *TOUSA* was insolvent.

The secured lenders also asserted the defense that the “savings

²⁵ *TOUSA*, 2009 Bankr. LEXIS 3311, at *242, quoting *Brown v. Third Nat’l Bank* (In re *Sherman*), 67 F.3d 1348, 1355 (8th Cir. 1991).

clauses” in their credit agreements functioned to reduce any loan obligations to the point where they would no longer be constructively fraudulent, and therefore the reduced amount of the obligations would continue to be secured by their liens and not be subject to further avoidance. The Bankruptcy Court emphatically rejected this defense and ruled that “savings clauses” are unenforceable as a matter of public policy. The court derisively noted that “savings clauses” are nothing more than attempts by “clever lawyers” to cause a borrower to preemptively forfeit the estates’ rights to pursue fraudulent transfer causes of actions. The court held “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.” *Id.* at *226.

Perhaps the most startling aspect of the *TOUSA* opinion is the breadth of the remedies imposed by the court. First, the court ruled that the judgment creditors had to disgorge \$403 million of the payments. The court found that \$403 million reflected the loan proceeds attributable to *TOUSA*’s subsidiaries. The court then avoided the liens and claims related to the \$500 million secured loan and ordered the secured lenders to disgorge all principal and interest received related to the loan, both pre-petition and post-petition, as well as all loan fees and the reimbursement of attorneys’ fees received from the debtors. The court further avoided the secured lenders’ liens on a \$207.3 million tax refund on the basis that the grant of the lien was a preference because the lien arose, not upon the grant of the security interest, but when the tax refund became payable, which was within 90 days of *TOUSA*’s bankruptcy.²⁶ Moreover, all amounts disgorged by the secured lenders and the judgment creditors were subject to a 9% prejudgment interest rate from the date of their receipt of the funds to the date of disgorgement.

The senior lenders and others argued that the court would be granting the subsidiaries’ estates a double recovery if the court ordered both (i) disgorgement of the money received by the judgment creditors and (ii) avoidance of the liens and claims in favor of the senior lenders that financed the payment to the judgment creditors. Section 550(d) of the bankruptcy code

prohibits such double recoveries. In a very controversial aspect of the opinion, the court ruled that there was no double recovery because all of the money disgorged would be put into a fund and the secured lenders would be entitled to the net proceeds of that fund after (i) the subsidiaries received money equal to the decline in value of their collateral from the date the liens were granted to the date of the court’s disgorgement order, and (ii) paying all of the estates’ and creditors’ committee’s fees and costs related to the litigation. Aside from the novel creation of a fund, the controversial element of this resolution is that, with the benefit of 20/20 hindsight, the court valued the damages suffered by the subsidiaries based on the decline in the value of their assets precipitated by the housing crises, a decline which had nothing to do with the granting of liens. The court essentially ruled that on the day the liens were granted, the subsidiaries’ assets were worth a to-be-determined amount and that the day the liens were avoided the assets were worth substantially less, and that the senior lenders had to compensate the subsidiaries for this diminution before the money they lent could be returned.

The secured lenders and the judgment creditors have appealed the Bankruptcy Court’s ruling. The Bankruptcy Court issued a stay of its order pending appeal on the condition that the judgment creditors post a \$531.2 million bond reflecting the \$403 million in avoidable payments plus interest. The Bankruptcy Court required that the secured lenders post a \$168.7 million bond (related to the tax refund) if they wanted to benefit from the stay.

Given the far-reaching holdings in *TOUSA* and *Crown Stock*, secured lenders may expect to see a resurgence of lender liability claims. As a consequence, borrowers may expect to see this increased risk factored into the pricing of their financing and addressed in the negotiation of new and restructured loans – especially if some of the traditional measures that secured lenders have taken to mitigate this risk such as savings clauses, affiliate guarantees and solvency opinions, are ineffective.

IS THE SECOND LIEN LENDER REALLY SILENT?

In *Ion Media*, the Bankruptcy Court was faced with interpreting an intercreditor agreement between the first lien lenders, who strongly supported a pre-negotiated plan of reorganization, and one second lien lender who opposed the plan. The second lien lender had also attempted to provide an alternative DIP loan and, in general, was pursuing an aggressive strategy to subvert the pre-negotiated plan. The court, in a strongly worded opinion, strictly interpreted the terms and conditions of the intercreditor agreement and ruled that the express terms deprived the junior

²⁶ The court’s rationale for concluding that the lien on the tax refund was granted within 90 days of bankruptcy was based on the holding that the tax return was not proceeds of a prior year’s tax losses but was instead a property interest that only arose when the tax return claiming the refund was filed. This interpretation of the date that liens on future tax returns are created rejects the more common approach that tax refunds are “proceeds” of a “general intangible” right to a future refund based on earlier tax losses and that liens on future tax refunds can be perfected at the time the loan is documented. The Bankruptcy Court’s approach adds uncertainty to the current expectations of secured creditors attempting to perfect liens in future tax returns and other similar efforts to perfect interests in proceeds of general intangibles.

creditor of standing to even assert its objections to the plan.²⁷

The Bankruptcy Court found that, as a matter of public policy, unambiguous intercreditor agreements should be enforced and that enforcing such agreements “leads to more predictable and efficient commercial outcomes and minimizes the potential for wasteful and vexatious litigation.” *Ion Media*, 2009 Bankr. LEXIS 3710, at *22. The court continued, “plainly worded contracts establishing priorities and limiting obstructionist, destabilizing and wasteful behavior should be enforced and creditor expectations should be appropriately fulfilled.” *Id.* Based on the “plainly worded” prohibitions against the junior creditor taking any action to “oppose, object to or vote against any plan of reorganization or disclosure statement the terms of which are consistent with the rights of the First Priority Secured Parties under the Security Agreement,” the court found that the junior creditor lacked standing to object to the plan or the extent of the senior creditors’ liens. *Id.* at *29. It is particularly notable that the Court also rejected the junior creditor’s argument that it had standing as an unsecured creditor to challenge the plan, given what has become a fairly standard provision in intercreditor agreements that permit junior creditors to exercise rights and remedies they otherwise would have as unsecured creditors.

Although the opinion expressly states that the junior creditor’s recent acquisition of the debt and clearly aggressive tactics did not color the result, the court began the opinion by noting that the junior creditor was an “activist distressed investor that purchased certain second lien debt . . . for pennies on the dollar.” *Id.* at *2. The repeated mention of the discounted price paid for the claim suggests a suspicion by the *Ion Media* court and others of, if not bias against, claims trading and other transactions where creditors acquire positions in the secondary markets with the expectation that they will hold fulcrum securities that will allow them to acquire an inexpensive equity position in the reorganized company (the so-called “loan to own” approach).

The *Ion Media* opinion is quite hostile to the actions taken by the junior creditor and even goes so far as to suggest that the creditor might be liable for substantial damages to the senior creditors and the estate. The court was particularly focused on the junior creditor’s decision not to seek a determination by the court of whether the intercreditor applied – instead it was “willful in its

treatment of the Intercreditor Agreement as inapplicable to it simply on the basis of its own untested theory as to what does and does not fall within the definition of collateral.” *Id.* at *33. The court continued by noting that the creditor’s strategy of treating the intercreditor as inapplicable resulted “in a material increase in the overall cost of administration in these cases. This added expense is unjustified.” *Id.*

The *Ion Media* case is significant because there are relatively few reported decisions regarding the enforceability of “silent” second lien waivers in intercreditor agreements. The decision presents a cautionary tale for junior creditors seeking to oppose restructurings supported by senior creditors by attempting to extricate themselves from intercreditor agreements. Not only did the court deny the junior creditor standing, but it made a number of findings that the senior lenders, and possibly the debtors, can use to bring an action for breach of contract and damages against the junior creditor. In light of *Ion Media*, the language of any potentially controlling intercreditor agreements should be parsed very closely with an eye towards their strict enforcement. This analysis is particularly important before an investor acquires a junior position for strategic reasons or otherwise attempts to advance an agenda in conflict with the path chosen by the senior creditors. With particular reference to the recent legal developments surrounding collective actions by a majority of lenders – the current legal climate might not be the most favorable to “outlier” creditors looking to exact leverage by upsetting the will of the majority.

CONCLUSION

The economic recession, coupled with the significant turbulence in the financial markets, no doubt contributed to the number of important bankruptcy cases that came down in 2009. A common theme that runs through all of these cases is the clear desire of most bankruptcy courts to expand the rights of all economic stakeholders in a case, sometimes at the expense of secured creditors. With a focus on facilitating restructurings, courts have demonstrated a willingness to strip senior secured creditors of bargained for rights, encourage collective action, unwind transactions deemed to be fraudulent transfers and strictly enforce intercreditor agreements. The extent to which these developments will directly impact pricing and access to capital in the syndicated loan market remains to be seen, but one thing is certain as we move into 2010 – secured lenders participating in the syndicated loan market need to be aware of and monitor these decisions, in order to adequately evaluate and assess the credit risks and strategy associated with loan originations, restructurings and workouts.

27 Although the Bankruptcy Court denied the junior creditor standing, it did address, and reject, the merits of each of its arguments. The court framed its review as its “independent obligation to review the Plan to make sure it satisfies the standards for plan confirmation set forth in section 1129.” *Ion Media*, 2009 Bankr. LEXIS 3710, at *33.