Recent Cases Highlight Potential Pitfalls for Distressed Investors

Skadden

January 2015

This article is from Skadden's *2015 Insights* and is available at skadden.com/insights.

Contributing Partners

Ron E. Meisler
Chicago

Ken Ziman
New York

Contributing Associate

Christopher M. Dressel
Chicago

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

Despite lower-than-average Chapter 11 activity in 2014, the legal landscape for distressed investors has continued to evolve, with significant legal developments in credit bidding, make-whole premiums and intercreditor agreements. By staying apprised of the evolving jurisprudence in these areas, distressed investors can mitigate risks that have foiled lenders in recent cases.

Credit Bidding

The credit bid is a key safeguard of secured lenders' rights in a Chapter 11 sale: It allows a lender to bid the debt it is owed in a sale of the debtor's assets, thereby ensuring that the collateral is not sold for an unreasonably low price. However, two 2014 decisions have unsettled the law on credit bidding, suggesting that courts have broad discretion to limit it based on a loose, "for cause" standard.

In *In re Fisker Automotive Holdings, Inc.*, a Delaware bankruptcy court held that a secured lender's credit bid could be limited to the (heavily discounted) price it paid for the secured loan. The court reasoned that unlimited credit bidding would preclude competitive cash bidding, as no one was likely to bid more than the amount of the secured lender's credit bid. The court also noted that the validity of the lender's liens on certain of the debtor's assets was disputed by the unsecured creditors' committee, leaving the amount of the lender's secured claim uncertain (even though the value of the assets underlying the dispute was fairly insignificant relative to the face amount of the secured debt).[1] A few months later, in *In re Free Lance-Star Publishing of Vicksburg, VA*, a bankruptcy judge in the Eastern District of Virginia also found cause to cap the credit bid of a secured lender who engaged in an "overly zealous loan-to-own strategy." The court noted that the secured lender engaged in affirmative "misconduct" intended to suppress interest in the debtor's assets.[2] The implications of *Fisker* and *Free Lance-Star* remain unclear, but the two cases suggest that the pendulum may be shifting toward greater scrutiny of credit bidding, potentially impairing secured lenders' ability to minimize losses in a sale context. At the same time, however, neither case suggests that bankruptcy courts have boundless discretion to limit credit bidding.

Make-Whole Premiums

The enforceability of "make wholes" (*i.e.*, contractual obligations to pay a specified premium if a loan is repaid prior to its stated maturity, which are designed to compensate lenders for the loss of future interest income) has been among the most hotly contested issues in recent bankruptcy cases. In *In re MPM Silicones, LLC* (*Momentive*), also in 2014, a bankruptcy court in the Southern District of New York rejected senior lenders' request for allowance of a make-whole premium. Because bankruptcy accelerates a loan, "payment" of a loan in bankruptcy is not a *prepayment* and, presumptively, does not trigger a prepayment premium. If the parties intend a contrary result, they must unambiguously contract for the premium. The *Momentive* court parsed the applicable indentures and concluded that they did not clearly require payment of the make whole upon acceleration.

Although the *Momentive* court rejected the lenders' make-whole claim, the court provided a roadmap to drafting make-whole provisions that are likely to withstand judicial scrutiny in bankruptcy. In brief, the credit documents must clearly require payment of the make whole upon (1) acceleration or (2) any payment prior to the stated maturity.[3] In other words, the debt document must clearly provide that the prepayment fee is payable if the loan's original maturity date has not yet passed.

Separately, most courts will (at least in the case of a fully secured creditor) enforce unambiguous make-whole provisions on the theory that such premiums are liquidated damages provisions that represent "charges" or "fees," which are allowable to fully secured creditors under Section 506(b) of the Bankruptcy Code. However, if the make whole grossly exceeds the lenders' possible losses, it may be vulnerable to attack as a penalty.[4] Anecdotal evidence suggests that lenders are responding to *Momentive* and similar decisions by drafting make-whole provisions that unambiguously require payment of a premium upon acceleration in bankruptcy. Accordingly, we expect that make-whole litigation increasingly will focus not on contract interpretation, but on the legal enforceability of the make-whole provisions at issue — *e.g.*, whether the premium is so large that it constitutes a penalty.

Intercreditor Agreements

The *Momentive* bankruptcy also highlighted another issue relevant to lenders: the enforceability of intercreditor agreements in bankruptcy. Intercreditor agreements typically contain a plethora of provisions governing the relative rights of senior and junior lenders in bankruptcy and are frequently structured to limit junior creditors' participation in bankruptcy proceedings.

These provisions can generate litigation, as junior lenders often seek to participate actively in bankruptcy despite the provisions. While outcomes are heavily fact-dependent, intercreditor provisions generally are enforced if the language of the agreement clearly proscribes the junior lenders' conduct.[5] Moreover, a trend in the case law has been to interpret agreements unfavorably against a party characterized as engaging in obstructionist behavior.[6]

When the agreement is ambiguous, bankruptcy courts often are reluctant to bar junior lenders' participation. In *Momentive*, for instance, the senior lenders challenged the junior lenders' (1) objection to the senior lenders' make-whole claims and (2) support for a cram-up plan. The court construed the agreement strictly and, because the intercreditor agreement provided for lien subordination and not claim subordination, ruled the agreement did not specifically bar the junior lenders from challenging the senior lien claims. Rather, the court said the agreement merely barred the junior lenders from challenging the senior liens. Accordingly, the court concluded that the junior lenders' actions, which did not put the senior liens in dispute, did not violate the intercreditor agreement.[7] We expect that decisions like *Momentive* will spur senior lenders to insist on greater precision in drafting intercreditor agreements and to negotiate for claim, rather than lien, subordination.

---

[1] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 59-61 (Bankr. D. Del. 2014).

[2] *In re Free Lance-Star Publ'g Co. of Vicksburg, VA*, 512 B.R. 798, 807 (Bankr. E.D. Va. 2014).

[3] *See* Hearing Transcript at 35:12-35:22, 36:8-36:11, 44:18-44:21, 40:11-40:18, *In re MPM Silicones, LLC*, No. 14-22503 (RDD) (Bankr. S.D.N.Y. Aug. 26, 2014).

[4] *See, e.g.*, In re Sch. Specialty, Inc., No. 13-10125 (KJC), 2013 WL 1838513, at *2-3, 5 (Bankr. D. Del. Apr. 22, 2013); *see also MPM Silicones, supra* note 7, at 46:4-46:8.

[5] *See, e.g., In re Ion Media Networks, Inc.*, 419 B.R. 585, 590, 593-595 (Bankr. S.D.N.Y. 2009).

[6] *See id*. at 587 (noting junior lenders' use of "aggressive bankruptcy litigation tactics" to "earn outsize returns"); *see also In re Erickson Retirement Cmtys.*, LLC, 425 B.R. 309, 315-20 (Bankr. N.D. Tex. 2010). *But cf. Boston Generating, LLC*, 440 B.R. 302, 316-20 (Bankr. S.D.N.Y. 2010) (narrowly construing intercreditor to permit participation by junior lenders not "engaging in…obstructionist behavior").

[7] Bench Ruling at 18:21-19:7, *In re MPM Silicones, LLC*, No. 14-08247 (RDD) (Bankr. S.D.N.Y. Oct. 14, 2014).