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# Bankruptcy Reorganization Plans and Cram Downs

## Strategies for Debtors and Creditors to Navigate Complex Plan Confirmation Rules

**A Live 90-Minute Audio Conference with Interactive Q&A**

**Today's panel features:**

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**Wednesday, July 22, 2009**

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**1 pm Eastern**

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## **OVERVIEW OF PLAN CONFIRMATION**

By John F. Isbell<sup>1</sup>

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## The Importance of Understanding the Plan Confirmation Process

- As others have noted:

There are two reasons to understand the confirmation procedure in chapter 11 of the Bankruptcy Code. One is obvious: to know what you have to do to win confirmation, or to block it, as the case may be. The other is less obvious, but perhaps equally important. Chapter 11 is the anvil upon which settlements are hammered out. . . . [T]o know what to settle for, you need to know what can be achieved under a chapter 11 plan.

JOHN D. AYER & MICHAEL L. BERNSTEIN, BANKRUPTCY IN PRACTICE 453 (2002).

# **The Requirements for Confirming a Chapter 11 Plan**

- The requirements for confirming a plan are set forth in Section 1129 of the Bankruptcy Code.
- There are sixteen (16) separate requirements specified in Section 1129(a), and all sixteen (16) must be met for a court to confirm a consensual plan under Section 1129(a) of the Bankruptcy Code.
- If all of the requirements are met other than Section 1129(a)(8)'s requirement that each class of claims and interests under the plan either (a) accept the plan or (b) be unimpaired under the plan, then a court may on request of the plan proponent utilize its “cram down” powers and consider confirmation of the plan on a non-consensual basis as to the impaired class(es) that have rejected the plan under Section 1129(b) of the Bankruptcy Code.
- Of the sixteen (16) separate requirements for confirmation, four (4) stand out for special mention.

# **Best Interest of Creditors Test**

- Section 1129(a)(7) of the Bankruptcy Code requires that each holder of a claim or interest either (a) accept the plan or (b) receive or retain under the plan property of a value, as of the effective date of the plan, not less than it would receive if the Debtor were liquidated under Chapter 7 on such date. This requirement is generally referred to as the best interest of creditors test and, effectively, acts as a floor below which (absent consent) distributions to creditors may not fall.

# Accepting Impaired Class

- Section 1129(a)(10) of the Bankruptcy Code requires that, if under the plan there is a class of creditors whose claims are impaired, then at least one class of claims that is impaired under the plan must vote in favor of the plan. Id. § 1129(a)(10). The acceptance of the class of impaired creditors must be determined without including the acceptances of any insiders. Id.

# Feasibility

- Section 1129(a)(11) of the Bankruptcy Code requires that, as a condition to confirmation of a plan, the bankruptcy court find that confirmation of the plan is not likely to be followed by the liquidation, or by the need for further financial reorganization, of the Debtor or any successor to the Debtor beyond that which might otherwise be provided for in the plan. In other words, the plan proponent must be able to demonstrate the plan is feasible and that the Debtor or its successor will not fail on a post-confirmation basis.

# Acceptance by All Impaired Classes

- Section 1129(a)(8) of the Bankruptcy Code requires that each class of claims and interests under the plan either (a) accept the plan or (b) be unimpaired under the plan.
- If all of the requirements are met other than this requirement, then a court may on request of the plan proponent utilize its “cram down” powers and consider confirmation of the plan on a non-consensual basis under Section 1129(b) of the Bankruptcy Code as to the impaired class(es) that have rejected the plan. Id. § 1129(b)(1).

# Voting on the Plan

- Claims and interests vote on the plan by class. A class of creditors accepts the plan if it is accepted by creditors that hold at least two-thirds ( $\frac{2}{3}$ rds) in dollar amount and more than one-half ( $\frac{1}{2}$ ) in number of the allowed claims that vote on the plan. Id. § 1126(c). A class of interests accepts the plan if it is accepted by parties that hold at least two-thirds ( $\frac{2}{3}$ rds) in amount of the allowed interests that vote on the plan. Id. § 1126(d).
- A mechanism exists to exclude – or “designate” – parties whose vote on the plan was not in good faith, was not solicited or procured in good faith, or was not solicited or procured in accordance with the provisions of the Bankruptcy Code. Id. § 1126(e). See generally *In re Allegheny International, Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990); *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989); *Trans World Airlines, Inc. v. Texaco, Inc. (In re Texaco, Inc.)*; 81 B.R. 813 (Bankr. S.D.N.Y. 1988); *In re Nautilus of New Mexico, Inc.*, 83 B.R. 784 (Bankr. D.N.M. 1988); *In re Snyder*, 51 B.R. 432 (Bankr. D. Utah 1985). All such “designated” votes are excluded in determining whether a class of claims or interests has accepted or rejected a plan. Id. § 1126(c), (d).

## Voting on the Plan (cont'd)

- A class of claims or interests that is not impaired is conclusively presumed to accept the plan and is not entitled to vote on the plan. Id. § 1126(f).
- Similarly, a class of impaired claims or interests is presumed to reject the plan if the plan provides that the holders of such claims or interests will not receive or retain any property under the plan on account of such claims or interests. Id. § 1126(g). Thus, a plan proponent must resort to cram down to confirm a plan where such a class of claims or interests exists.

# Requirements for Cramdown

- As noted earlier, Section 1129(a)(8) of the Bankruptcy Code requires that each class of claims and interests under the plan either (a) accept the plan or (b) be unimpaired under the plan. If all of the requirements for confirmation are met other than the requirement of Section 1129(a)(8), then a court may on request of the plan proponent utilize its “cram down” powers and consider confirmation of the plan on a non-consensual basis as to the impaired class(es) that have rejected the plan under Section 1129(b).
- Specifically, to confirm a non-consensual plan, the plan proponent must show that (1) the plan does not discriminate unfairly against the impaired non-consenting class and (2) that the plan is fair and equitable to the impaired non-consenting class.

# Unfair Discrimination

- Under Section 1129(b), a plan must not discriminate unfairly against an impaired non-consenting class. Accordingly, a plan can discriminate against an impaired non-consenting class as long as it is fair. Also, a plan can discriminate unfairly, if the class votes to accept the plan.
- In general, a plan does not unfairly discriminate against an impaired non-consenting class if other similar classes of creditors are paid the same amount and there is a legitimate reason for the discrimination in treatment -- even if other classes are paid more quickly than the impaired non-consenting class.

# Fair and Equitable Test

- In general, a plan is fair and equitable to impaired non-consenting classes if the plan does not violate the Absolute Priority Rule and no creditor is paid more than they are owed.

# Modified Rule of Absolute Priority

- In general terms, under that modified Absolute Priority Rule no class of creditors or of interests may receive or retain anything of value under the plan unless either (a) the claims of all senior classes of claims or interests have been paid or provided for in full or (b) each senior class of claims or interests whose claims have not been paid or provided for in full have accepted the plan by the requisite majorities required by Section 1126 of the Bankruptcy Code. See 11 U.S.C. § 1129(b). See generally *Bank of America v. 203 N. LaSalle Street Partnership*, 526 U.S. 434 (1999); *Case v. Los Angeles Lumber Products Co., Ltd.*, 308 U.S. 106 (1939).
- Once that modified rule is understood, the focus shifts to the nature of the claim or interest held by the non-accepting holder, as Section 1129(b)(2) of the Bankruptcy Code provides for different cram down treatments to be considered “fair and equitable” depending on the nature of the claim or interest at issue.

# Secured Creditor Cram Down

- A plan proponent may obtain confirmation of a plan even if it has been rejected by a class of impaired secured creditors, provided that the plan provides that the class of impaired secured creditors will receive one of the following three treatments for their claims:
  - The holder of such claim shall retain the liens securing its claim and shall receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim and having a value, as of the effective date of the plan, at least equal to the value of such holder's interest in the estate's interest in such property; or
  - For the sale, subject to Section 363(k) of the Bankruptcy Code,<sup>2</sup> of any property that is subject to the liens securing such claim, free and clear of such liens, with such liens to attach to the proceeds of such sale; or

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[2] Section 363(k) of the Bankruptcy Code preserves the right of a secured creditor to credit bid at a sale of its collateral.

## **Secured Creditor Cram Down** (cont'd)

- For the surrender to the secured creditor of its collateral or for such other realization by such holder of the indubitable equivalent of such secured claim.

See 11 U.S.C. § 1129(b)(2)(A). See also *In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346 (5th Cir. 1989).

# Unsecured Creditor Cram Down

- A plan proponent may obtain confirmation of a plan even if it has been rejected by a class of impaired unsecured creditors, provided that the plan provides that either:
  - each holder of a claim of such class shall receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim, or
  - the holder of any claim or interest that is junior to the claims of such class will not receive or retain any property under the plan on account of such junior claim or interest.

See 11 U.S.C. § 1129(b)(2)(B).

# Cram Down of Equity Interest Holders

- A plan proponent may obtain confirmation of a plan even if it has been rejected by a class of impaired equity interest holders, provided that the plan provides that either:
  - each holder of an interest of such class shall receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest, or
  - the holder of any interest that is junior to the interests of such class will not receive or retain any property under the plan on account of such junior interest.
- See id. § 1129(b)(2)(C).

# The Debtor's Burden

- In general, the plan proponent bears the burden of proof on all confirmation issues.
- Accordingly, the plan proponent must make an evidentiary record that supports a finding, by preponderance of the evidence, that each of the 16 plan requirements are met in cases of a consensual plan
- In the case of a non-consensual plan, the plan proponent must demonstrate that (1) all of the 16 plan requirements are met, other than the rejection of the plan by an impaired class, and (2) that the rejecting impaired class is treated fair and equitable under plan.

# ***PLAN CONFIRMATION ISSUES***

## **Bankruptcy Reorganization Plans and Cram Downs**

### **Strategies for Debtors and Creditors to Navigate Complex Plan Confirmation Rules**

**Strafford Publications CLE Teleconference – July 23, 2009**

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## Section 1129(b) Confirmation Requirements

- Bankruptcy Code Section 1129(b): A Chapter 11 plan shall be confirmed if “it does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”
- Unfair discrimination: Any disparity of treatment between different classes of creditors must be justified under the Bankruptcy Code.
  - Does the proposed discrimination have a reasonable basis?
  - Is the proposed discrimination necessary for reorganization?

## The “Fair and Equitable” Requirement

- With respect to a class of secured claims, the plan must provide:
  - That the secured creditors retain their liens - whether the collateral is retained by the debtor or transferred to another entity - to the extent of the allowed amount of their secured claims; and that each secured creditor in the class receive on account of its claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the Plan, of at least the value of the creditor's interest in the estate's interest in such property;
  - For the sale - subject to the secured creditor's right to credit bid pursuant to Bankruptcy Code Section 363(k) - of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale and be treated as required the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
  - For the realization by such holders of the indubitable equivalent of such claims.

## The “Fair and Equitable” Requirement

- With respect to a class of unsecured claims, the plan must provide:
  - That each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
  - The holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

# The Absolute Priority Rule

- Absolute Priority Rule: A senior creditor is entitled to be paid or allocated all value from the debtor before any of that value is paid or allocated to a junior class.
  - A senior class of creditors may consent, as a class, to junior classes receiving value even if that senior class is not paid in full or allocated all of the debtor's reorganization value.
  - If all of the debtor's reorganization value is allocated to senior classes, and they are still not paid in full, absolute priority is *not* violated so long as no junior class participates on account of its junior interest. interests that is impaired under, and has not accepted, the plan.”
- Three key elements of the Absolute Priority Rule:
  - What "property" of the debtor's estate will the junior class receive?
  - Is the junior class receiving value "on account of" a prior interest?
  - How is the property being value?

# New Value Exception to the Absolute Priority Rule

- [W]here the debtor is insolvent, the stockholder's participation must be based on a contribution in money or money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 60 S. Ct. 1, 84 L.Ed. 110 (1939).
- Does the new value exception still exist?
  - Arguments supporting new value exception:
    - Bankruptcy Code has done nothing to reverse pre-Code case law.
    - New value exception is consistent with Absolute Priority Rule.
    - Principles that Debtor should not be discriminated against as a result of its bankruptcy filing.
  - Arguments against new value exception:
    - The plain language of the Bankruptcy Code does not mention the exception.
    - The exception would impermissibly undermine delicate balances struck in Bankruptcy Code Section 1129 and elsewhere in the Bankruptcy Code.
    - The exception breeds unproductive litigation and is contrary to the origins of the absolute priority rule.

# New Value Exception to the Absolute Priority Rule

- Debt-for-equity and “gift” plans
- Bankruptcy court valuation of new value
  - Exit financing.
  - Asset acquisition.
  - Rights offering.
  - Allocation of equity in Reorganized Debtor among creditors or shareholders providing new value and creditors receiving less than the amount of their claims.
- Bank of America, NT & SA v. 203 North LaSalle Street Partnership, 526 U.S. 434, 119 S. Ct. 1411, 143 L.Ed. 2d 607 (1999).
  - “On account of” means “because of.”
  - Degree of causation between prior claims or interests and opportunity to provide new value in exchange for interest in Reorganized Debtor.
  - The exclusive ability of a debtor’s equity holders to proposed a plan is a form of “property,” similar to an option.
  - The adequacy of an old equity holder's proposed new value should be tested against some form of market valuation.

# New Value Exception to the Absolute Priority Rule

- New Value Exception, restated: Junior classes of creditors or equity owners may participate in a plan, without full payment to the dissenting senior creditors, if they make a new contribution -
  - in money or money's worth – release of pre-petition claims likely not sufficient;
  - that is reasonably equivalent to the value of the new equity interests in the reorganized debtor – valuation litigation, with varying tests and standards applied by court;
  - that is necessary for implementation of a feasible reorganization plan – new value is the most feasible source of new capital, and the reorganization of the debtor must be feasible;
  - The contribution must be substantial – this requirement is not applied by all courts, and has been viewed as subsumed within the 3 other tests.
- “LaSalle” market test:
  - Must every new value plan be tested by a competing plan?
  - Role of Section 363(b) auction process.
  - Reorganization versus liquidation.

# Section 1111(b)(2) Election For Undersecured Creditors

- Bankruptcy Code Section 1111(b) provides:
  - (1) (A) A claim secured by a lien on property of the estate shall be allowed or disallowed under [Bankruptcy Code] Section 502 the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless
    - (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or
    - (ii) such holder does not have such recourse and such property is sold under [Bankruptcy Code] Section 363 or is to be sold under the plan.
  - (B) A class of claims may not elect application of paragraph (2) of this subsection if —
    - (i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or
    - (ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under [Bankruptcy Code] Section 363 or is to be sold under the plan.
- (2) If such an election is made, then notwithstanding [Bankruptcy Code] Section 506(a), such claim is a secured claim to the extent that such claim is allowed.

## Section 1111(b)(2) Election For Undersecured Creditors

- The Section 1111(b)(2) election converts an unsecured deficiency claim into a claim fully secured by the electing creditor's collateral.
  - The creditor's entire claim becomes secured.
  - The debtor's plan is required to provide payments to the secured creditor that total the amount of the claim, but with a present value equal to only the secured claim.
- The secured creditor maintains a lien on its collateral to secure the full amount of its allowed claim, irrespective of the bankruptcy court's valuation of the collateral.
- Provides additional protection to a partially secured creditor when the secured creditor believes that the bankruptcy court's determination has undervalued the collateral, or that the treatment accorded unsecured creditors is so unattractive that the electing secured creditor is willing to waive its unsecured deficiency claim, taking into consideration:
  - The size of the prospective deficiency;
  - The availability of assets to pay deficiency claims; and
  - Alternate treatments proposed by the plan proponent.

# Section 1111(b)(2) Election For Undersecured Creditors

- Election by Class:
  - At least two-thirds in amount and more than half in number of the allowed claims of such class.
    - When a number of creditors hold claims on a parity, one with the other, which are secured by liens of equal rank on the same property.
    - In the case of publicly issued secured debentures where an indenture trustee holds a lien on behalf of the debenture holders.
    - In the case of a private placement or institutional financing where one institution holds a lien on property for itself and as agent for a group of creditors.
    - Mechanics lienors may also comprise such a class.
  - May be made "at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix
  - Election must be in writing and signed, "unless made at the hearing on the disclosure statement."
  - When the terms of a plan of reorganization are changed with respect to the secured debt after the disclosure statement has been approved, or if the disclosure statement is sought to be amended in a way which affects the secured creditor, a court may extend the time to make the election.
- The election can be used by the undersecured or originally nonrecourse creditor to prevent an attempted cash out under Bankruptcy Code Section 1124 for an amount less than the value of the entire claim.

# Secured Creditor Cram Down

- “Cram Down” refers to the power of the bankruptcy court to force confirmation of a Chapter 11 Plan notwithstanding the dissent of one or more classes of creditors or ownership interests
- Difficult policy issue: does the Bankruptcy Code’s principle of debtor rehabilitation justify the imposition of substantial valuation risks on secured creditors?
- Common cram down methods:
  - Abandonment of collateral.
  - Giving secured creditor “indubitable equivalent.”
  - Secured creditor retains a lien on its collateral to secure its allowed secured claim, and receives on account of its claim deferred cash payments totaling at least the allowed amount of the claim with a present value of at least the value of the creditor’s “interest in the estate's interest in such property.”

# Indubitable Equivalent - Secured Creditor

- Bankruptcy Code Section 1129(b)(2)(A)(iii): Fair and equitable treatment with respect to a class of secured creditors under a Chapter 11 Plan includes the realization by such secured creditors of the indubitable equivalent of their claims.
- “Something is dubitable if it is open to doubt or question and, conversely, is indubitable if it is not open to any doubt ... . One might say, therefore, that the evidence of the requisite indubitable equivalent is present if, under the treatment proposed in the plan, there is no reasonable doubt but that the bank will receive the full value of what it bargained for when it made the contract with the debtor. In other words, is there any real doubt but that, as a matter of fact, the bank will be paid in full?” *In re Freymiller Trucking, Inc.*, 190 B.R. 913, 915-16 (Bankr. W.D. Okla. 1996) (quoting from the 1981 edition of *Webster's Unabridged Third New International Dictionary*).
- What is Indubitable Equivalent?
  - Abandonment, or other unqualified transfer of the collateral, to the secured creditor.
  - Granting of substitute collateral, where its value exceeds, and is likely to continue to exceed, the allowed secured claim
  - Providing an oversecured creditor no payments for a period, followed by transfer if the collateral is not sold by a certain time, where the bankruptcy court is satisfied that the collateral's value will “always” exceed the secured claim.
- What is not Indubitable Equivalent?
  - Providing a payment stream with a present value of less than the allowed amount of the claim.
  - A partial transfer of the collateral.
  - “Dirt for debt” plans, where a debtor proposes to transfer only so much of the collateral as is necessary to satisfy the secured creditor's claim.

# Classification Issues

- Bankruptcy Code Section 1122 requires the classification of claims or interests:
  - (a) Except as provided in [Section 1122(b)], a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
  - (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.
- All substantially similar claims are not required to be placed in the same class. For example, a debtor might wish to cure and reinstate a particularly low interest loan while paying other creditors or giving them notes at a more current interest rate.
- Key classification issues include:
  - Whether all claims of the same type *must* be placed in the same class?
  - When and under what circumstances substantially similar claims may be placed in separate classes?
  - Whether the unsecured portion of an undersecured claim – i.e., a deficiency claim - can be placed in its own class separate from any other unsecured claim?

## Classification Issues

- “Substantially similar” means similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor.
  - Contractual subordination usually results in separate classification.
  - The nature of the claim or interest is relevant to classification, not the identity of the holder.
- Claims may be divided into separate classes if separate classification is reasonable.
  - Claims of the same kind and the same rank involving the same property may be included within a single class.
  - Claims secured by different properties usually are not substantially similar.
  - Claims may not be separately classified where the only rationale offered for separate classification is that the claims are disputed.
  - While separate classification of unsecured claims may be appropriate where claims of certain unsecured creditors are subordinated in favor of other unsecured creditors, claims that are subject to equitable subordination should be classified without consideration to subordination.
  - Separate classification of unsecured claims may be appropriate for future claims.
- Claims cannot be classified to gerrymander the vote on the plan.
- Should unsecured deficiency claims be classified separately from general unsecured claims?
  - Not if the sole purpose for separate classification is to create an impaired class that will vote in favor of the plan
  - (Bankruptcy Code Section 1129(a)(10) requires that a plan be accepted by at least one impaired class of claims, determined without including any acceptances of the plan by insiders).

# Present Value and Interest Rates

- "Present value" reflects the time value of money.
  - \$10 today is worth more than \$10 paid a year from today.
  - Calculation of present value is determined by commonly accepted practices and formulas.
- Present value analysis calculates the value of property or cash to be received in the future.
  - Assumes that the payments or distributions of property will be made as promised.
  - Compensation for the risk that the promised payments or distributions will be made is reflected in components of the analysis such as the interest or discount rates used.
- Market conditions and feasibility considerations are significant in selecting a rate at which an amount today could be invested to yield the promised amount when it is promised to be paid.
- Four components of a present value calculation:
  - The amount of each payment (including any accrued and payable interest);
  - The timing of each payment;
  - The number of payments; and
  - The effective discount rate.

# Present Value and Interest Rates

- The bankruptcy court must determine an appropriate rate to serve as the measuring standard.
  - Court's determination is based on the facts of a given case.
  - Courts have used many different rates and formulas.
- The Supreme Court determined that an appropriate interest rate to be used in discounting to present value in the cramdown context is best determined by use of a formula approach based upon the prime rate of interest. Till v. SCS Credit Corporation, 541 U.S. 465; 124 S. Ct. 1951; 158 L. Ed. 2d 787 (2004).
- The plan proponent bears the burden of proof on all confirmation issues, and must establish the applicable discount rate and entity valuation.
  - If the plan proponent does not carry its burden, confirmation should be denied, regardless of whether opponents to the plan have introduced contrary evidence.
  - Once the plan proponent satisfies its burden, opponents must make their own presentation on each issue.

# Present Value and Interest Rates

- Chapter 11 cram down rate may bear relation to the rate an efficient market would produce. Debtor in Possession (DIP) financing rates may not be relevant to the cramdown rate.
- Three common present value methods:
  - Creditor's cost analysis: looks at costs incurred by the creditor in being treated as provided for in the plan.
  - Coerced loan analysis: treats any deferred payment of an obligation under a plan as a coerced loan, such that the rates used in the analysis would correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and risk.
  - Specifically crafted discount-rate analysis: adds to the interest rate paid for treasury notes – i.e., a riskless cost of money - a premium based on a number of factors, including:
    - The term;
    - Physical, financial and personal quality of security;
    - Risk of repayment, future default or financial condition of the borrower;
    - Profit component which reasonably could be expected to be provided to the creditor forced by the plan into lender/borrower relationship .

# Enterprise Valuation

- Since the plan must be fair and equitable as to each dissenting class, where a class of claims or equity is to be eliminated (thus, assumed to be a dissenting class), holders in the impaired class can force a valuation of the reorganized Debtor to ensure that whoever does receive the equity interests in that entity will not be overcompensated.
- “Value is a word of many meanings. It may suggest actual or original cost, replacement cost, book value, fair market” value, liquidation value, scrap value and a host of other concepts. The term, however, gathers its meaning in a particular situation from the purpose for which a valuation is being made.” Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Ry. Co., 318 U.S. 523, 540, 63 S. Ct. 727, 738, 87 L.Ed. 959, 994 (1943) .

# Enterprise Valuation

- Common valuation methods:
  - Capitalized earnings: the capitalization of average annual income, determined based on average prospective earnings and an appropriate capitalization rate
  - Discounted Cash Flow Analysis: estimates value based upon the ability of the business to generate cash for its owners, determined by the sum of two calculations:
    - the net present value of projected cash flows over a chosen period; and
    - the net present value of the company's "terminal" value at the conclusion of such projections
    - Valuation determined based on cash flow, discount rate / weighted average cost of capital, terminal value.
  - Market-based offers may serve as the basis for entity valuation.
- Capitalized earnings tend to be backward-looking, to rely on accounting earnings and to select discount rates for the debtor's income by analogy.
- Discounted cash flow analyses are designed to be forward-looking, to rely on actual earnings generated and to calculate discount rates for the specific debtor

# Unique Issues for Real Estate Bankruptcies Strafford



Lorraine S. McGowen  
July 22, 2009



## Topics

- General Growth Properties
- Authority of borrower to file – BRE's
- Commercial single asset real estate case
- Springing recourse guaranties
- Second-lien loans
- Impact of General Growth Properties case
- Other Bankruptcy Issues

# General Growth Properties

- Second largest shopping mall REIT in the United operating a nationwide network of shopping malls in 44 states
  - Has 750 wholly-owned debtor and non-debtor subsidiaries and affiliates
  - Largest consolidated real-estate chapter 11 bankruptcy case
  - Along with the REIT, General Growth caused over 150 of its affiliated special-purpose entities to file voluntary chapter 11 bankruptcy petitions
- General Growth filed a motion to use cash collateral held by the BREs
  - Over objections by various lenders, special servicers, investors, bankruptcy court authorized use of all cash, wherever located.
  - CMBS investors granted an “adequate protection lien” on cash in General Growth’s centralized cash management system
  - CMBS investors’ “adequate protection lien” senior to the lien granted to dip lenders

# Bankruptcy “Remoteness”: What Does It Mean?

- The SPV’s purpose is to reduce the likelihood that the borrower may become the subject of a voluntary or involuntary bankruptcy petition.
- “Bankruptcy Remote” — Not “Bankruptcy Proof”
- Accomplished by:
  - Minimizing the risk that the BRE would seek to commence a voluntary bankruptcy case
  - Minimizing the risk that creditors of the parent/sponsor would obtain the BRE’s assets to satisfy claims against the borrower

## How Is It Achieved?

- The SPV generally is a newly formed entity whose operations are restricted to a single purpose, that of purchasing, owning, operating the Property. In theory, this restriction prevents the SPV from incurring obligations to third parties who could commence an involuntary bankruptcy case against SPV.
- Restrictions on the types of indebtedness that the BRE can incur.
- Restrictions on ability of parent or affiliate commencing or inducing an involuntary bankruptcy petition against the BRE (the so-called “no petition” clause) or inducing the borrower to commence a voluntary bankruptcy petition.
- Restrictions on the ability of the BRE to commence a voluntary bankruptcy case: the BRE’S organizational documents require the consent of one or more independent directors or similar persons to commence a voluntary bankruptcy case. In theory, the independent directors owe a fiduciary duty to the SPV’s creditors not to seek protection in bankruptcy.
- Restrictions on the types of business in which the BRE is engaged: the BRE's organizational documents prohibit the BRE from engaging in any other business activities other than those arising from the ownership or operation of the real property or project itself.

# Why Do Lenders Care?

## Commercial Real Estate Issues

- “Automatic stay” risk
- Potential use or sale of the BRE’s assets by the parent/sponsor in parent/sponsor’s bankruptcy case
- Potential imposition of senior, junior or equal liens in favor of others on the BRE’s assets
- Substantive Consolidation

# Elements of a Single Asset Real Estate Case

What is a “single asset real estate” debtor?

- Debtor must have real property that constitutes a “single property” or a “single project, that is not residential real property with fewer than 4 residential units
- Real property that generates substantially all of the gross income of the debtor
- Debtor does not conduct substantial business on the property other than operating the real property (and related incidental activities)

# Single Asset Real Estate Issues

- Why does it matter?
  - Secured creditor's rights are enhanced in a single asset real estate case: relief from the stay to enable lender to foreclose
  - Debtor required to file a confirmable plan of reorganization within first 90 days after the filing of the bankruptcy case OR
  - Debtor required to commence making monthly interest payment to the secured creditor
- **Practice tip:** 90 day period may be extended by the court for cause by order entered within the 90-day period; Additionally, debtor can extend the 90 day period by filing a motion seeking a determination that the debtor is a "single asset real estate" debtor. Period commences on the later of 90 days after commencement of case or 30 days after the court determines that the debtor is a single asset real estate debtor.

# Examples of Single Asset Real Estate Cases

## Single Asset R/E Case

- Development of identical semi-detached house
- Development of a single-family home development
- Resort development covering separate, but contiguous, parcels with a well-developed concept plan

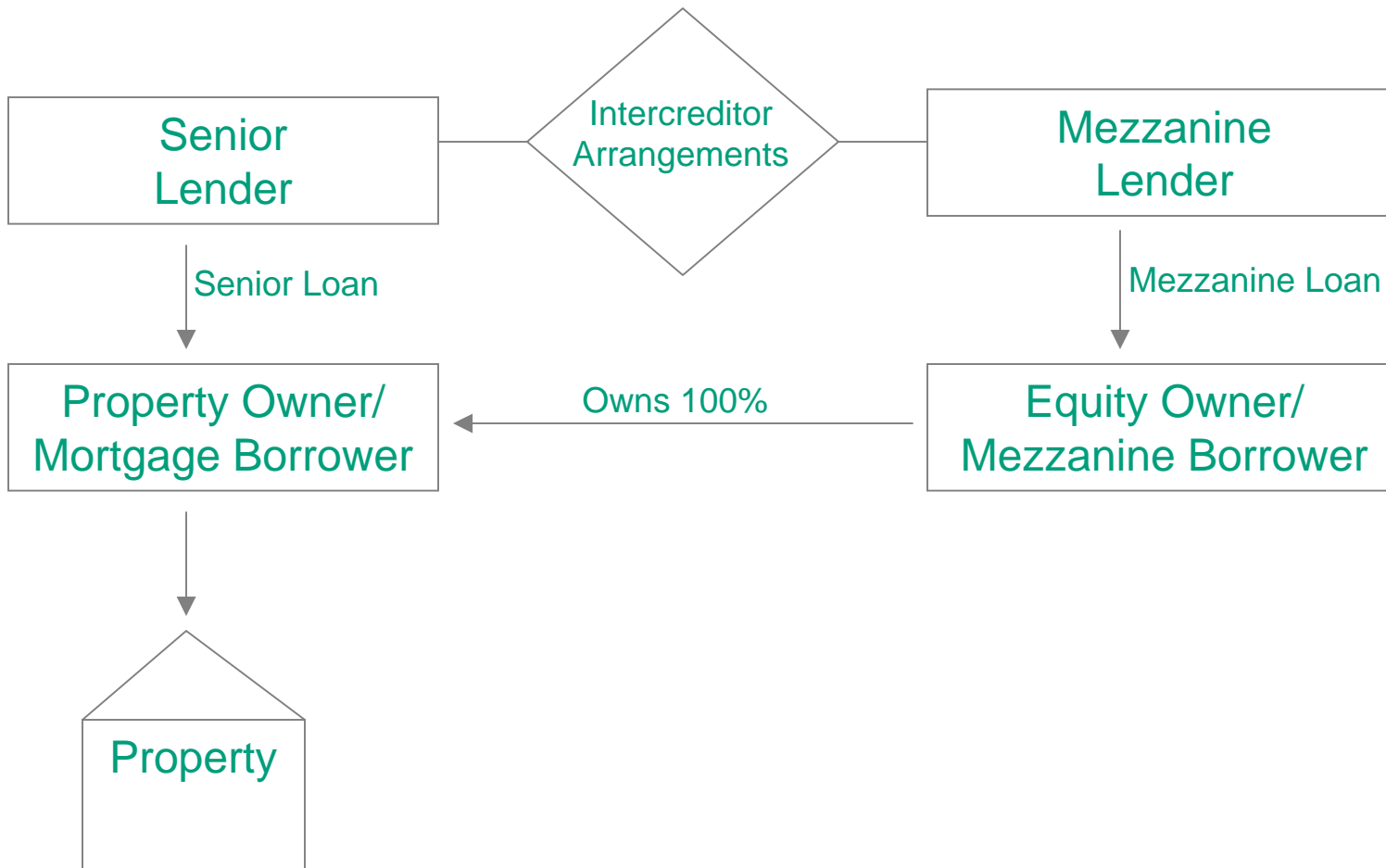
## Not A Single Asset R/E Case

- Adjacent parcels where one was developed and leased and the other was undeveloped, with no plans to combine property
- Growing, replenishing and selling timber
- Operation of a golf course, which sold memberships, charged fees, sold merchandise
- Operation of a marina with ancillary services

# Springing Recourse Guaranties

- As a source of repayment for bad boy acts or omissions, an BRE is of little worth to a lender. Thus, lenders resorted to requiring parent/sponsor to provide nonrecourse carve-out guaranty, which is a guaranty of the BRE's nonrecourse carve-out liabilities by the BRE's parent company (or by members or principal shareholders).
- “Bad boy” guaranty are aimed at preventing the borrower from taking actions:
  - Fraud
  - Gross negligence or willful misconduct
  - Waste
  - Misapplication or conversion of operating funds, or insurance or condemnation proceeds and similar funds
  - Commencement of a voluntary or involuntary bankruptcy case involving the BRE in violation of the BRE’s organizational documents
  - “Willfully interfering” with the lender's pursuit of its rights and remedies under the loan documents.

# SECOND LIEN LOANS INTERRELATIONSHIP AMONG PARTIES



# SECOND LIEN LOANS: TENSION AMONG CREDITORS

- Mezzanine Lender Concerns
  - “Loan to own”: right to obtain equity in bankruptcy and to take control of debtor
  - Right to credit bid
  - No payment subordination; cap on senior loan
  - Enterprise value exposure (not faced by fully-secured senior lender)
- Subordinated Debt Concerns:
  - Cap on senior debt
  - Option to purchase senior debt
  - Reservation of unsecured creditor rights

# TENSION AMONG CREDITORS

## Common Second Lien Intercreditor Provisions

- Lien Subordination, but not payment subordination (senior lender acknowledges that second lien is not subject to contractual payment subordination)
- Waiver of Right to Contest Liens
- Agreement to Secure Loans Equally: neither will obtain additional collateral not provided to the other

## Standstill of Subordinated Debt

- **Effect:** Gives senior debt control over enforcement actions against collateral
- **Trend:** (i) 90-270 days after event of default and acceleration by subordinated debt; (ii) extension if senior debt enforcing remedies; and (iii) waiver of right to challenge senior debt's exercise of remedies
- **Practical Implications:** Second lien lender/subordinated lender permitted to take certain acts to preserve rights that do not "adversely impact" the senior lender
  - Remedies rarely exercised outside of bankruptcy; (ii) Uniform Commercial Code ("UCC") requires good faith and commercial reasonable exercise of remedies; and (iii) senior debt not likely to let standstill expire.

# TENSION AMONG CREDITORS

## Option to Purchase Senior Debt

- **Effect:** Allows subordinate debt to take control
- **Trend:** (i) option to purchase all senior debt at par after acceleration of senior debt; (ii) some standstill period will still usually apply for subordinated debt; and (iii) once standstill period ends, subordinated debt must exercise option and close within short period of time
- **Practical Implications:** (i) valuable right for subordinated debt; and (ii) option period may make option difficult for subordinated debt to exercise

## Reservation of Unsecured Creditor Rights

- **Effect:** Depending on collateral value, subordinated debt may hold unsecured deficiency claim against debtor
- **Trend:** Subordinated debt may exercise rights and remedies as unsecured creditors, subject to subordination
- **Practical Implications:** Valuable right for subordinated debt

# Impact of General Growth: Open Questions

- Are the BREs proper debtors in the bankruptcy case?
- Will the “bad boy guaranties” spring into full recourse?
- Are the BREs “single asset real estate” debtors?
- What structural changes will be wrought in the CMBS world?
- Will the debtors seek to substantially consolidate all or some of the General Growth debtors and non-debtors

# Other Bankruptcy Issues

- **Substantive Consolidation**
- **Rejecting property management/administrative services agreement.**
  - **Who will operate the Property:** If the parent/sponsor rejects the administrative services agreement, the rejection constitutes a breach of the agreement entitling the BRE to assert a prepetition damage claim (usually unsecured) in the parent/sponsor's bankruptcy case. The parent/sponsor's and the BRE's rights and obligations under the agreement terminate and the BRE may contract with another entity to maintain the Property.
  - **Time for assumption or rejection.** The parent/sponsor will be entitled to a reasonable time to make an informed judgment on whether to assume or reject the agreement.
    - Any party to the agreement, however, may ask the bankruptcy court to order the parent/sponsor to determine within a specified period of time whether to assume or reject the agreement.
    - As a practical matter, the court will be more likely to expedite the parent/sponsor's decision to assume or reject the agreement if the parent/sponsor is derelict in performing its duties under the agreement and thereby harming the BRE's creditors.

# Substantive Consolidation

## Ensuring the BRE's Separate Corporate Identity

- A bankruptcy-remote BRE must be designed, and in fact operate, as an entity with its own corporate identity, separate from the parent/sponsor.
- Failure to satisfy either requirement could cause a bankruptcy court in the parent/sponsor's bankruptcy case to disregard the BRE's separate identity and subject the BRE's creditors and assets to the risks of the parent/sponsor's bankruptcy case, thereby defeating the BRE's purpose.
- "Two critical factors" in substantive consolidation analysis are:
  - whether creditors dealt with the entities as a single economic unit or 'did not rely on their separate identity in extending credit,' or
  - whether the affairs of the debtors are so entangled that consolidation will benefit all creditors."

# Factors Considered For Substantive Consolidation

- BRE should have separate officers, directors, and shareholders, in whole or at least in part.
- BRE should pay its own expenses, including professional fees, from its own bank accounts.
- BRE should establish and maintain separate books, records, bank accounts.
- BRE should have separate assets. The BRE's bank account should be maintained in the name of the BRE.
- BRE should have separate liabilities. Invoices and other statements of account from third parties must be addressed and mailed directly to the BRE.
- BRE should have separate offices, separate telephone number, and separate stationery.
- The BRE should have adequate capitalization, financing, working capital.
- Lack of intercompany guarantees of payments of indebtedness, or mutual guarantees or payments of indebtedness of third parties, or cross-collateral agreements.
- Books and records of each company are accurately and properly kept in accordance with nonarbitrary standards.

# Factors Considered For Substantive Consolidation

- Proper regard for and observance of the formalities of corporate organization e.g., directors' meetings, minutes.
- No commingling of funds. No commingling of assets.
- The parent/sponsor and BRE should be engaged in different businesses, or perform different functions in the same business.
- Lack of intercompany transfers or exchanges of assets.
- Lack of intercompany loans.
- Separate financial statements issued or to the extent the financial statements are consolidated with the parent/sponsor, that such financial statements contain a footnote stating that the BRE is a separate legal entity, the assets of which are not available to pay creditors of the parent/sponsor or its affiliates.
- Separate tax returns filed and the BRE should have its own tax identification number. If consolidated or combined federal or state tax returns are filed, the BRE and its parent should be parties to a written tax sharing agreement, pursuant to which the BRE pays its allocated share of the taxes (or obtains its allocated share of any refunds).