CreditorWars In The New Millennium

NEAL L. WOLF

This is the first in a seven-part series of articles on today's bankruptcy world of business bankruptcy. The first article, which follows, is entitled "CreditorWars In the New Millennium." This article addresses the changed posture of modern chapter 11 cases involving large corporations.

The next six articles will appear in succeeding issues of *Corporate Counsel*. The second article, entitled "Don't Look Back . . .," will address the subject of inter-creditor disputes in bankruptcy. The third article, "Coming Soon to a Bankruptcy Court Not So Near to You," will address the use, effect, and possible abuse, of the venue sections of the bankruptcy laws. The fourth article, entitled "Take My Assets – Please!" will discuss the current debate in the bankruptcy world over the employment or over-employment of Chapter 11 to achieve, not a true debt restructuring or business reorganization, but a simple sale of assets. The fifth article, entitled "The Rock – Part II," will address the impregnability or vulnerability to creditor attack of Special Purpose Vehicles and allegedly "bankruptcy-remote" entities. The sixth article, entitled "Twelve Angry Creditors," will consider the ways aggrieved creditors and shareholders seek to pierce the corporate veil and impose liability on, or otherwise penalize, officers and directors. The seventh and final article, "The Business of Bankruptcy," will address the competition for cases among, and payment of, lawyers and financial advisors.

June 4, 2009 will mark my 35th anniversary as a bankruptcy lawyer. In those years, I have seen many significant changes in bankruptcy practice – including changes in the substantive law, changes in procedure, changes in the role of the bankruptcy court itself, and changes in the customs and practices of bankruptcy lawyers.

Former Practice

One very fundamental and interesting change that has taken place gradually over the past few years has been the change in the nature and motivations of the various non-debtor constituencies in bankruptcy cases. In the past, the secured lender behaved like a secured lender and the unsecured (largely trade) creditor (usually acting under the rubric of a formal committee of creditors) comported itself like an unsecured trade creditor. Each knew its place in the statutory priority scheme and its role in the developing bankruptcy case.

In those days, the debtor controlled the case in all ways from the start. Today, at times, the debtor seems to be only an incidental player on the bankruptcy stage. The real drama is to be found in the inter-creditor relationships.

The secured lender was typically a bank or finance company. Having funded a loan to the debtor, and having taken what it thought was a duly and properly perfected security interest in all of the assets of its borrower, it sought repayment in full – nothing more, nothing less. This meant repayment of principal, together with accrued and accruing interest, attorneys' fees, and costs. The last thing in the world that yesterday's secured lender wanted was the keys to the front door of the business itself. It was not in the business of manufacturing widgets, operating a shopping center, selling goods at retail, or developing real estate. Indeed, in those days, the most effective threat that a debtor could make to its secured lender was often the threat to turn the assets over to the lender through a deed in lieu of foreclosure, a "friendly" or consensual foreclosure, or some other mechanism. Indeed, in some ways, one of my greatest achievements as a lawyer came in the late 1980s when, in connection with my representation of a huge and structurally complex developer of more than one hundred resort, commercial, and residential properties, I offered every single one of the properties (together with accompanying entitlement, environmental, mechanics lien, negative cash flow, investor, and operational issues) back to the lenders. They were absolutely horrified at the prospect. An across-the-board ceasefire was agreed to, enabling the developer to restructure or sell assets on a one-off basis, maximize the return to creditors, and avert a costly and extended stay in bankruptcy court.

In those days, the unsecured trade creditor was typically the entity or person that had actually provided goods and/or services to the debtor. It was concerned about, not merely the payment of its past-due invoices, but the financial recovery and continued viability of the debtor so that the latter could continue to purchase goods and services from its trade creditors. If the case were converted to a liquidation case, the trade creditor would often be "out of the money" in the sense that the realizable value of the assets would not extend beyond the amount of the secured lender's claim. The unsecured creditor would recover pennies on the dollar, if anything at all. More importantly, if the doors of the debtor closed forever, it would lose future sales (and the ability to recover any short term losses from profits generated in the future). The latter concern often, if not usually, outweighed the trade creditor's concern about its outstanding claim. Indeed, it was often willing to compromise the claim as a part of an in- or out-of-court financial restructuring under which the debtor continued to conduct its business and to purchase goods and services from the trade creditor. Hence, the trade creditor sought to "leverage" the secured lender in order to negotiate a bigger slice of the reorganization pie and to assure that the secured lender would not force such liquidation. The trade creditor would seek to identify chinks in the armor of the secured lender. Such chinks might include the failure of the supposedly secured creditor to perfect its security interest properly in accordance with state law or the exposure of the secured creditor to some form of "lender liability" claim.

The Current Regime

Today's bankruptcy world is exponentially more complex, for a host of reasons. Often, in a terrible liquidity crunch, both before and/or after the commencement of its chapter 11 case, the debtor is compelled to borrow from a "hard money lender" at great cost and under highly-undesirable terms. That lender, possibly a hedge fund, may actually hope for a default that will entitle it to acquire ownership of the entity in a foreclosure or a bankruptcy case. At the same time that it makes its secured loan to the debtor, the lender may acquire pieces of both subordinated debt and equity issued by the borrower/debtor. The secured lender's consent to use of its cash collateral or a new loan in the bankruptcy case is usually tied to, among other things, prior approval rights with respect to the debtor's plan of reorganization and the borrower's waiver of any and all defenses and challenges to the lender's claim and liens.

Both before and after commencement of large cases, holders of unsecured claims are besieged by (and frequently succumb with gratitude or resignation to) "claims traders" that are seeking to purchase the unsecured claims at greatly discounted prices. The new holders of these claims have no interest in anything other than an expeditious sale of the debtor that will enable them to turn a quick profit on the transaction. For these, and other reasons (primarily, the over-leveraging of companies), most chapter 11 cases are not true stand-alone restructuring or reorganization cases; they are liquidation cases in which the business is sold. Many of the true unsecured trade creditors are either paid in full at the outset of the case under controversial "critical vendor" orders or assured of full payment on emergence. For this reasons, these creditors now play a far less significant role in the course of the case. Often, the only trade creditors that play an active role in the case are the large holders of disputed, "litigation" claims and those whose goods and services are no longer needed in the debtor's future operations.

The senior secured lenders, the holders of an often-impregnable secured claim against an illiquid debtor that is governed by harsh and expensive terms, are really in control. The real trade creditors are protected by their critical vendor status or the need of the company to continue to operate. Hence, often as not, the battle is between holders of different classes of funded debt. To be sure, the unsecured creditors still look for and seek to exploit chinks in the armor of the senior secured lenders. Other issues and disputes often become the subject of litigation however. These issues include the rights and obligations of the parties under inter-creditor and/or subordination agreements and the enforceability of many of the provisions thereof. I will discuss the new battleground in the next article in this series.

Neal L. Wolf is a partner with Butler Rubin Saltarelli & Boyd LLP, a Chicago litigation and bankruptcy boutique. He is chair of firm's Business Reorganization, Bankruptcy and Insolvency practice group. The views expressed are personal to the author.

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