Bankruptcy Commission: Secured Lending OK by Us

By Vincent Ryan | December 4, 2012

An American Bankruptcy Institute commission studying an overhaul of the U.S. Bankruptcy Code believes the proliferation of secured debt and the trading of bankruptcy claims, among other developments, have made the code outdated. But the co-chairs of the commission made it clear on a Monday conference call that they do not see either practice as inherently harmful to businesses seeking to survive the Chapter 11 process.

"There's been an assumption by some, an incorrect one, that because [the commission] identified those two externalities — claims trading and the growth of secured debt — that we were identifying them as problems to be solved," said Robert Keach, an attorney at Bernstein Shur and co-chair of the ABI's Commission to Study the Reform of Chapter 11. But that was never the commission's intention, he said. What the commission was pointing out by including those two changes in its mission statement, said Keach, was that they create an environment not envisioned in the 1978 code.

The 1978 Bankruptcy Code, partly revised in 2005 with the Bankruptcy Abuse Prevention and Consumer Protection Act, was designed to rehabilitate businesses and preserve jobs and tax bases at the state, local, and federal levels, the commission has said. But the involvement of outside creditor parties in bankruptcy has caused other aims — such as liquidation of the debtor to maximize creditor recovery — to gain prominence.

Richard Levin, chair of the restructuring practice at Cravath, Swaine & Moore, said, "There's no longer a situation where the creditors who lent the money or sold the goods are sitting at the table negotiating a restructuring, and that just changes how people approach these things."

Some witnesses who spoke at the ABI's six field hearings earlier this year expressed concern that the commission could recommend stricter and more rigid oversight of secured lending or advocate reducing the rights of secured lenders or claims traders in a Chapter 11 case.

When there are no unencumbered assets in a company filing bankruptcy, it can be a roadblock to other creditors seeking recovery. "You do have companies that enter Chapter 11 fully leveraged, where the entirety of their value is consumed by first- , second- , third- , and sometimes fourth- and fifth-lien debt," Keach said. So "when a company is in trouble there is less equity in the assets to deal with people like employees and tort claimants and other stakeholders." The key is to find a way to "get value to those other stakeholders while still recognizing the legitimate rights of the secured parties," he said.

But the commission also recognizes that innovations in secured debt have made financing available to companies that otherwise wouldn't be able to obtain credit, Keach said. At a field hearing in mid-October, Edith Hotchkiss, a professor of finance at Boston College, said having

senior secured lenders can actually benefit a Chapter 11 company. Citing academic studies, Hotchkiss said senior lenders “often take the view that they can realize more value from a security interest in a debtor’s assets by lending additional capital to facilitate a reorganization plan than [by] pushing for the firm’s liquidation.”

Bankruptcy claims trading, while not necessarily a destructive practice, has grown in recent years, especially with the large bankruptcy cases of Lehman Brothers, MF Global, and AMR Corp.

“There’s no one who wants to restrict claims trading in any way, because it brings liquidity to trade creditors, who otherwise might have had to wait three years to get money on their claims,” Keach said on the call. But the bankruptcy code needs reform, because while a traditional trade creditor has an interest in the long-term survivability of the company as a customer, “the person who acquires a claim [on the secondary market] may have those interests or may not,” he pointed out.

Claims trading — amounting to an estimated $40 billion in each of the past two years — can complicate creditor voting on plans of reorganization, said Levin. “What happens when someone buys multiple claims? Do they get a vote for each claim, or do they only get one vote because they are one creditor?” he asked. While the bankruptcy courts are good at working out the issue case by case, “wouldn’t it be better if we could all agree on a set of rules that we don’t have to slog through the courts to figure out?”

Keach pointed out that a number of witnesses have made the point that any changes to the bankruptcy code affecting secured debt could have a broader impact on the credit markets, and that any recommendation from the commission has to take that into consideration. “The degree that that concern exists has been brought home to us and we take it to heart,” he said.

But Keach did say the commission would like to see empirical studies that show how changing the favorable position of a creditor could affect the pricing or availability of debtor-in-possession (DIP) financing or secured credit in general.

The ABI’s bankruptcy reform commission has six more field hearings scheduled from February to June of 2013. Those hearings will focus on issues such as governance of troubled companies, the role of DIP financing, and the treatment of collective-bargaining agreements and employee pensions, said Keach.

The commission’s aim is to come up with a proposal in the next year or two to overhaul the U.S. bankruptcy code, “the thrust of which we hope the [insolvency] community will back and that we can take to Congress,” Levin said.

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