DEVELOPMENTS IN THE WORLD OF "LOAN-TO-OWN"

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I. The Loan-to-Own Strategy

An emerging strategy many hedge and private equity funds (each a "Fund," and collectively the "Funds") are pursuing is known as the "loan-to-own" investment. In this type of investment, a Fund's investors acquire debt, and sometimes certain amounts of equity or management control, such as voting power or board seats, from a lender of a distressed company (each a "Company," and collectively the "Companies"). The Fund often buys the debt at a deep discount, then nudges the Company toward a bankruptcy filing where the Fund can take advantage of the economic leverage associated with the face amount of the debt it acquired to turn the debt into an equity ownership of the Company in the chapter 11 process.

Funds are the main players in these loan-to-own transactions. Moreover, Funds' opportunistic investment strategy of investing in distressed companies with a view of gaining a controlling position in the capital structure of such Companies is more aggressive, and entails more risk, than the investment principles of traditional secured creditors, whose primary goal is a long term return of capital. As Funds seek to maximize returns in the distressed debt arena, they often possess a much higher tolerance for risk and litigation than the more traditional and conservative financing institutions.

Although acquiring discounted loans is the preferred method, Funds generally will also consider providing debtor-in-possession financing ("DIP") to the distressed company with terms that facilitate the transition of reorganization value and equity to the Fund investors as stalking horse bidders. These terms often include: (i) requirements for quick section 363 sales; (ii) confirmation of the investors' liens and claims; and (iii) short time limits on the creditors' ability to challenge the Fund's prepetition liens.

II. From Debt Investment to Controlling Equity Positions–Credit Bids

The bankruptcy tool that is typically used to transform pre-petition discounted debt and equity acquisition into post-petition complete and clean ownership by the Fund is the right to credit bid at a public auction sale of a Company under section 363(k) of the Bankruptcy Code. As a matter of theory, credit bidding allows Funds to set the bidding threshold at the face amount of the debt, rather than at the discounted value paid. The theory being, if the fair market value of the Company is closer to the value paid by the Fund prepetition, the creation of the competitive bidding threshold at the artificially high face amount will reduce the likelihood of competitive bids, which is the desired outcome for the Fund.

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Absent competitive bidding there is no chance of any increase in the cash resources of the Company that would typically fund distributions to creditors. Thus, in many cases the unsecured creditors are left with little or no recoveries on their claims. The classic loan-to-own scenario, resulting in a rapid section 363 sale to the prepetition Fund, is nothing more than a liquidation with a predetermined result, benefiting only the top ranks of the creditor food chain.

Creditor committees and other creditors have asserted that such proceeding contradict the historical purpose of chapter 11, which is to rehabilitate the debtor for the benefit of all its creditors, and provide the debtor with a fresh start.

The question is: what recourse is there for creditors? What arguments can creditors assert to assure an auction sale occurs at fair market values and with a greater possibility that the sale for the benefit of the Fund will also result in benefits and recoveries for unsecured creditors?

III. Challenging Credit Bids

A. Lack of Competition in the Bidding Process

Under section 363(k) of the Bankruptcy Code:

> At a sale under [Section 363(b) of the Code] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.[2]

Thus, in a sale of assets outside the ordinary course of business, a secured creditor is allowed to bid the allowed amount of its claim against the purchase price*, unless the court orders otherwise*. The express terms of section 363(k) limit the right to credit bid to holders of an "allowed" claim. Consequently, the holder of a claim that has not been determined to be valid may not bid its claim.[3] Under section 502(a), a claim is deemed "allowed" to the extent a party in interest has not objected.[4]

Therefore, the express language of the statute provides two opportunities: (1) the court has discretion to "order otherwise" to condition or limit a credit bid upon cause shown, opening the door to a variety of potential arguments;[5] and (2) a debtor or committee facing a loan-to-own may object to the Fund's claim by way of an adversary proceeding challenging the allowance of

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[2] 11 U.S.C. § 363(k) (2008).

[3] *See, e.g., National Bank of Commerce of El Dorado v. McMullan*, 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996); King, *Collier on Bankruptcy*, at 363.09 n.1 (15th ed. Rev. 2006).

[4] 11 U.S.C. § 502(a) (2008).

[5] *See, e.g., In re Tberoux*, 169 B.R. 498, 499 n.3 (Bankr. D. R.I. 1994); *see also In re Takeout Taxi Holdings, Inc.*, 307 B.R. 525, 536 (Bankr. E.D. Va. 2004).

the prepetition debt holder's liens (assuming, of course, that there are valid bases to do so). Once the objection is lodged, the credit bid should at least be delayed pending determination of the merits of the objection.

The principal argument that should be employed to limit or condition a credit bid is the fundamental unfairness of setting a competitive bid threshold at the face value of debt – such debt having been purchased at a discount – when it can be shown that, especially in relation to the time at which the debt was purchased, the purchase price of the debt reflects the market value more accurately than does the face amount. Competitive bidding is at the core of the section 363 auction process and the courts should be receptive to conditioning credit bidding to achieve such an outcome.

Moreover, it will be difficult for the Fund to demonstrate any prejudice resulting from a requirement, for example, that the bidding threshold begin at the price at which the debt was acquired. To the extent the Fund is in the auction to acquire the Company, it is free to bid against all comers – and to have normal bid protections and breakup fees. If the Fund chooses not to bid, it will nevertheless recover its actual investment and the breakup fee. On the other hand, if there is competitive bidding, the estate may receive cash beyond the Fund's investment that can be distributed to unsecured creditors.

The bottom line is that the value of the Company that exceeds the discounted prepetition investment should inure to the benefit of the company's unsecured creditors, not artificially accrete from the estate by defaulting to the face value for competitive bids.

B. Equitable Subordination

There are other potential arguments that can be used to demonstrate "cause" to limit or condition loan-to-own Fund's credit bids.

Under section 510(c) of the Code, to the extent the Funds and/or Companies may have engaged in inequitable conduct which has injured other creditors, the claims of the investors could be equitably subordinated to the injured creditors' claims.[6] The requisite "inequitable conduct" could include: (i) fraud, illegality and breach of fiduciary duties, including improper dealings with an "insider;" (ii) undercapitalization; and (iii) use of the Company as a mere instrumentality or alter ego.[7]

Although an equitable subordination claim is typically leveled against an "insider" (and thus may be stronger if the investors are also equity holders), non-insider claims may also be subject to equitable subordination. Moreover, equitable subordination may be granted even without creditor misconduct if necessary to prevent injustice and insure fairness for creditors.[8] These arguments depend, of course, on the facts and could conceivably include a Fund having

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[6] 11 U.S.C. § 510(c) (2008).

[7] *See, e.g.*, *In re Repository Technologies, Inc.*, 363 B.R. 868 (Bankr. N.D. Ill. 2007).

[8] *e.g., In re Cutty's-Gurnee, Inc.*, 133 B.R. 934, 958-959 (N.D. Ill. 1991) (citation omitted).

unduly exercised control over a Company to maximize a Fund's own return and subsume other assets in its liens to the detriment of unsecured creditors.

C. Good Faith

Showing a breach of fiduciary duties by directors or officers could involve proving, among other things, inadequate consideration of options and lack of good faith. Creditors can object to confirmation of a Fund's restructuring plan because the Fund has not proposed such plan in good faith. Under Section 1129(a)(3) of the Code, a "court shall confirm a plan only if . . . [t]he plan has been proposed in good faith and not by means forbidden by law."[9] The standard for meeting such good faith requirement, as stated by the court in *In re Johns-Manville Corp.*, requires a showing that "the plan was proposed with honesty and good intentions and with a basis for expecting that a reorganization can be effected."[10]

In other words, a court may determine good faith is lacking where a Fund has proposed a plan under the pretext of financially resuscitating a Company, but with the true motive of converting its debt position into a controlling equity position.[11]

D. Recharacterization

Creditors can assert that debt owed to the Funds should be treated as equity, thus preventing the Funds from including such debt in a credit bid, an effect similar to equitable subordination. Recharacterization – one of the broad powers Section 105 of the Code confers to bankruptcy courts – is appropriate where the facts show that a debt transaction was actually an equity infusion.[12] Courts often examine the following factors to determine whether to recharacterize debt: (i) the names given to the debt instruments; (ii) the presence of a fixed maturity date, interest rate and payment schedule; (iii) the repayment source; (iv) the adequacy of capitalization; (v) the identity of interest between the creditor and the lender; (vi) the loan security; (vii) the company's ability to obtain alternative financing; (viii) any subordination of the advances; (ix) the use of the advances to acquire capital assets; and (x) the presence of a sinking Fund for repayments.[13] Some courts have also looked to the ratio of shareholder loans to capital and the amount or degree of shareholder control as additional factors in a recharacterization action.[14]

None of the above mentioned factors is decisive, however, and all such factors distill to one essential concept: the more a debt transaction reflects the characteristics and intent of an

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[9] 11 U.S.C. 1129(a) (2008).

[10] *In re Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988).

[11] *See* Section IV.A.(iii), *infra*.

[12] 11. U.S.C. 105 (2008).

[13] *See In re Autostyle Plastics, Inc.*, 269 F.3d 726, 749-750 (6th Cir. 2001) (*citing In re Roth Steel*, 800 F.2d 625, 630 (6th Cir. 1986)).

[14] *See, e.g.*, *In re Repository Techs., Inc.*, 363 B.R. 868, 881 (Bankr. N.D. Ill. 2007).

arm's length debt deal, the more likely it is that it will be treated as a debt, rather than equity, transaction.[15]

E. Marshaling

To the extent the Fund has liens on non-debtor assets, creditors can argue that the equitable doctrine of marshalling precludes the credit bid.[16] The doctrine of marshaling prevents a senior creditor that can satisfy its debt from either of two Funds from depleting a Fund on which a junior creditor relies exclusively to satisfy its debt. Instead, it compels the senior creditor to turn for satisfaction to the non-overlapping Fund.[17] Where the Fund has liens on other assets, a credit bid might implicitly constitute an attempt to recover their debt from the debtors' assets, rendering the estate worthless and precluding recoveries by other creditors; all while the investors have other available collateral.

In addition, if any of the claims underlying the credit bid are subject to potential avoidance, for example as fraudulent transfers or preferences, the credit bid might not be valid as to the amount so avoidable.

F. Preferable Alternatives / Valuation

Creditors can also make a process-based argument against a restructuring plan by pointing out the procedural shortcomings of a Company's management in selecting a Fund's plan. Such shortcomings could include the Company's failure to pursue alternative transactions and/or proposals, and restrictions limiting the scope of the search for transactions. These arguments, however, are inherently fact-specific and difficult to support. A Company might, for example, be desperate for immediate financing that allows it to pay short term obligations on which it would otherwise default.[18] Moreover, to the extent members of a Company's management are interested parties, the Company can insulate its decision by having such interested officers or directors abstain from the decision-making process or by delegating to a wholly independent committee the task of evaluating restructuring plans.

Valuation arguments are also inherently fact-specific and unlikely to succeed. Courts often view such arguments as lacking in objective support, especially when the Fund's valuation is based on information obtained through its status as a debt holder and the Fund's opponents fail to back their arguments with their purses. In other words, courts prefer a market approach to

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[15] *Cold Harbor*, 204 B.R. at 904, 915 (Bankr. ED VA 1997).

[16] Although unsecured creditors generally do not have standing to compel marshaling of assets, "some courts have allowed unsecured creditors this relief treating them under the doctrine as lien creditors . . . to prevent a senior creditor from arbitrarily destroying the rights of a creditor that has less security." *In re Hale*, 141 B.R. 225, 227 (Bankr. N.D. Fla. 1992).

[17] *See Meyer v. U.S.*, 375 U.S. 233, 237 (1963); *In re Tampa Chain Co.*, 53 B.R. 772, 777 (Bankr. S.D.N.Y. 1985) ("The bankruptcy courts have long had the power to marshal the debtor's assets in order to effectuate on [sic] equitable distribution of funds to creditors of the debtor's estate.").

[18] *See, e.g.*, *In re Granite Broadcasting Corp., et al.*, 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

valuation, and a Fund's valuation may be the most accurate indicator of fair market value of a Company.[19]

IV. Courts' Treatment of Arguments Opposing Loan-to-own

A. Loan-to-own Cases

Recent court decisions involving challenges to credit bids in loan-to-own situations have favored the Funds, and include the following:

1. SubMicron

In *Cohen v. KB Mezzanine Fund II LP*,[20] the Fund ("KB") held secured debt of the debtor, SubMicron Systems Corp. ("SubMicron") that was subordinated to a first lien lender. During the period leading up to SubMicron's bankruptcy, KB made additional subordinated loans to SubMicron. In connection with a section 363 sale, KB contributed their subordinated claims to a proposed purchaser of the SubMicron assets in exchange for a 31 percent interest in the purchaser.

The bid consisted primarily of a credit bid based upon KB's assigned claims, along with a relatively small amount of cash used to pay off the first lien lender and administrative claims. The bid did not provide for a payment to unsecured creditors. SubMicron received no other bids. The creditors' committee objected to the sale, arguing that KB's claims should be recharacterized as equity or equitably subordinated, and that Akrion should not be permitted to credit bid in the full amount of KB's claims, because the actual value of the secured position was less than the claims. The Delaware district court rejected these arguments and approved the sale.

On appeal, the Third Circuit affirmed. The Third Circuit determined that the facts regarding the parties' intent supported the district court's decision. These facts included that the parties called the transfers at issue "debt," the transfers had a fixed maturity date and interest rate and the obligations were recorded as secured debt on SubMicron's 10-Q SEC filing and UCC-1 financing statements. The Third Circuit also held that KB did not dominate SubMicron's board so as to support recharacterization. Furthermore, the Third Circuit held that the lack of documentation for certain fundings did not compel recharacterization of the transfer.

The Third Circuit also held that KB was entitled to bid the face amount of its claims, and were not limited to bid the value of the secured collateral. As a result, under the *SubMicron* reasoning, loan-to-own lenders may bid the full amount of their claim, even if it is greater than the value of the assets, and thereby usurp the debtor's going concern value.

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[19] *See, e.g.*, *In re Oneida Ltd.*, 351 B.R. 79 (Bankr. S.D.N.Y. 2006).

[20] *Cohen v. KB Mezzanine Fund II LP*, 432 F.3d 448 (3d Cir. 2006).

Finally, the Third Circuit rejected the committee's equitable subordination argument, finding that KB's transfers did not injure creditors, because without the loans, SubMicron would have had to liquidate without the possibility of a sale to an alternate purchaser.

2. *Radnor Holdings*

In *The Official Committee of Unsecured Creditors of Radnor Holdings v. Tennenbaunz Capital Partners LLC et al.*,[21] the loan-to-own fund (collectively, "TCP") loaned the Radnor Holdings Corp. and its affiliates ("Radnor"), $95 million and purchased $25 million of Radnor's preferred stock. Radnor also executed an investor rights agreement giving TCP the right to, among other things, appoint a board member and increase the board representation if Radnor missed an EBITDA target. Radnor provided TCP with solvency certificates in connection with the loan.

Radnor missed its EBITDA target for 2005 by $20 million and requested another equity investment from TCP to meet its liquidity needs, claiming that it still expected a higher EBITDA in 2006. TCP refused to make the equity investment, but instead loaned Radnor an additional $23.5 million with the prior consent of Radnor's unsecured noteholders. Subsequently, Radnor continued to miss their projections and Radnor's lenders ceased funding.

Radnor filed a chapter 11 petition, with TCP acting as the DIP lender and stalking horse bidder. The court established an expedited sale process, which permitted the creditors' committee to bring a complaint against TCP and permitted TCP to credit bid the amount of its claim subsequently determined to be valid. The committee brought a variety of claims against TCP, including recharacterization, equitable subordination, breach of fiduciary duty, objection to claim, avoidance of lien and preference.

The bankruptcy court rejected the committee's challenges. Focusing on the parties' intent under the SubMicron decision, the court ruled that the transfers were not equity because: (i) the parties treated the advances as debt; (ii) it was appropriate for a lender to extend additional credit to a distressed borrower to protect its existing loans; (iii) despite the fact that Radnor missed its 2005 EBITDA target, there was no evidence that TCP "knew" Radnor could not meet its 2006 EBITDA target; and (iv) TCP did not have control over Radnor's day-to-day operations so as to compel recharacterization. The court found that TCP did not engage in any misconduct, but rather acted in good faith with a view to maximize the debtors' value, and thus equitable subordination was not appropriate. Finally, the court rejected the committee's claims regarding breach of fiduciary duty, finding that the TCP loans actually increased Radnor's solvency, Radnor's corporate documents exculpated directors from liability for the duty of care and Radnor's directors were entitled to attempt to continue to operate using loans to turn the company around.

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[21] *Official Comm. of Unsecured Creditors of Radnor Holdings v. Tennenbaunz Capital Partners LLC*, 353 B.R. 820 (Bankr. Del. 2006).

3. *Granite*

In re Granite Broadcasting Corp., et al.,[22] involved competing plans of restructuring for Granite Broadcasting Corporation and five of its wholly-owned subsidiaries ("Granite") submitted by Silver Point Capital Finance LLC ("Silver Point"), holder of approximately 80% of Granite's 9.75% senior secured notes (the "Secured Notes"), on the one hand, and by parties (the "Preferred Holders") holding over 50% of Granite's 12.75% cumulative exchangeable preferred stock (the "Preferred Equity"), on the other hand. The court had to determine whether Silver Point's plan was proposed in good faith, and whether such plan undervalued Granite.

By the time of the confirmation hearing for Silver Point's proposed plan of restructuring (the "Plan") in April of 2007, Granite had sustained net operating losses for the previous three years. Moreover, Granite had been unable to make the $19.4 million interest payment on the Secured Notes in June of 2006 and entered into a credit facility with Silver Point to allow it to make such interest payment, a component of which was convertible into 200,000 shares of preferred equity. In addition, Silver Point provided Granite with a senior secured, superpriority revolving loan of up to $25 million pursuant to a DIP. The Preferred Holders objected to confirmation of the Plan on the grounds that the Plan lacked good faith and that it violated the "fair and equitable" rule of the Code.

The Plan provided, among others, (i) that Silver Point would receive $200 million in new secured notes, (ii) the balance of Granite's debt to be converted into substantially all of Granite's new equity, (iii) that unsecured creditors would receive a 100% recovery subject to a cap of $11 million, and (iv) that holders of the Preferred Equity would receive approximately 2% of the new equity and warrants, and (v) certain releases, exculpations and indemnifications to Granite's officers and directors of claims by Granite. The Plan did not entail a change in Granite's Board of Directors (the "Board"). The Preferred Holders' competing plan included, among others, a preferred stock investment that would cover the $19.7 interest payment due Silver Point, referenced in general terms, but did not commit to, a subsequent recapitalization, permitted the Preferred Holders to assume immediate control of the Board, and contained provisions relating to Granite's controlling shareholder and chief executive officer ("Cornwell").

The Preferred Holders argued the Plan lacked good faith because Granite proceeded with the ulterior motive of "enriching and protecting Cornwell and absolving the other directors from their breaches of fiduciary duty."[23] The Preferred Holders' good faith argument – based on an examiner's report alleging possibly breach of fiduciary duties by Granite's directors and officers – focused on the Board's procedures in selecting the Plan, such plan being, from the Preferred Holders' perspective, inferior to their own. According to the Preferred Holders, the Board selected the inferior Plan because the Board allowed itself to be dominated by Cornwell. Although it admitted that "better procedures should have been instituted to put [Granite's] restructuring decisions into the hands of wholly independent Board members," the court was

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[22] *In re Granite Broadcasting Corp.*, 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

[23] *Id.* at 128.

convinced "not only of the basic good faith of [Granite] and [its] professionals but also of the lack of any damages as a result of the June 2006 transactions [with Silver Point.]"[24]

In reaching this conclusion, the court pointed to the lack of a clear and feasible plan from the Preferred Holders that could have been effectuated given the time constraints, the Preferred Holders' deliberate decision not to compete with Silver Point in submitting a plan that included a long term recapitalization, and the Preferred Holders' demand of immediate control of the Board.[25] In other words, the Board's decision-making process – especially considering the lack of damages resulting therefrom – was more reasonable than the Preferred Holders claimed it was, such process having ended with the Board's selection of a patently superior restructuring plan.

The court also addressed and summarily rejected a valuation challenge by the Preferred Holders, who alleged that the Plan "undervalued the new common stock and that the Plan will provide Silver Point and the other [holders of secured notes of the same class of Silver Point] with a recovery in excess of their allowed claims."[26] According to the court, the valuations posited by the Preferred Holders' experts were based on (i) projections of Granite's future performance for which there was no support, (ii) several unsupported assumptions, including an immediate reduction in corporate overhead in excess of 50%.[27] The court also permitted the Preferred Holders to make a proposal to purchase Granite that would value in Granite beyond the debt, but the Preferred Holders' offer established that they would not be willing even to pay the debt in full. Quite simply, the Preferred Holders' plan was "patently unconfirmable" and had "no feasibility."[28]

B. Lessons to be Gleaned from the Court Decisions

Knowing that creditors will make the arguments discussed above in challenging Funds, there are procedures that Funds – and Companies that prefer the Funds' plans to those of other creditors – employ to insure the success a loan-to-own investment. In other words, Funds can avoid creating, or stepping into a situation involving bad facts that make a loan-to-own strategy susceptible to attacks from other creditors. Moreover, to the extent the facts of a loan-to-own case support a Fund's opponents, a lack of concrete damages resulting from the Fund's inequitable conduct may have the effect of making such conduct moot.

The decision in the *Granite* case is indicative of the high burden creditors face in succeeding on a claim for breach of fiduciary duties and/or lack of good faith. Certainly, in the wake of *Granite*, any Company that prefers the plan of a Fund now knows to appoint a

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[24] *Id.* at 133.

[25] *Id.* at 134-136.

[26] *Id.* at 140.

[27] *Id.* at 142.

[28] *Id.* at 144-145.

committee comprised of independent members of its board of directors to evaluate such plan and any alternatives. Taking steps to insure the decision-making process is free from defects will provide a Company's board of directors the leniency afforded to corporate actions viewed under the business judgment rule. Likewise, Funds can nip arguments for equitable subordination in the bud in the same manner as with good faith arguments, i.e., avoiding inequitable conduct. As to the common argument of recharacterization, the lesson here seems to be "leave no smoking gun." To the extent parties appropriately document loan transactions, such documentation will support a court's determination that any financing purporting to be a loan is, in fact, a loan. On the other hand, failure to engage in the appropriate documentation process was not detrimental to the Fund in the *Submicron* decision.

CONCLUSION

Although the *SubMicron* and *Radnor Holdings* cases constitute wins for loan-to-own investors, the results of any challenge to limit credit bids of such lenders will depend on the facts of each case. So far, there have been very few reported challenges. In particular, the good faith of the lenders (including the degree to which they may have directed further advances to set up their credit bid) and the "arms-length" nature of the loan transaction as a true debt deal will be tested in connection with potential attacks on credit bids on recharacterization and equitable subordination grounds. Considering these matters will almost always be hotly contested, it is only a matter of time until a loan-to-own case with different facts (for instance where substantial unsecured creditors did not consent to loans as in *Radnor Holdings*) will result in a decision against the Fund.

The recent decision of the *Granite* case, however, further vindicates the loan-to-own strategy and inexorably leads to the conclusion that only a truly egregious set of facts will be enough for a Funds' opponent to succeed in its objections.