

## Cash Collateral Orders Revisited Following ResCap

*Law360, New York (April 08, 2014, 1:53 PM ET)* -- Every restructuring professional knows that cash is king when planning a successful Chapter 11 filing. Continuing to fund payroll, satisfy taxes, and procure the goods and services necessary for operating without interruption are essential elements of seamlessly transitioning into bankruptcy. To achieve any one of these things, access to sufficient funding is paramount.

But a debtor's right to use its cash, as well as the cash proceeds of other assets, becomes problematic if all or most of that cash is encumbered. In that case, the debtor must obtain the secured creditor's consent to use the cash, or obtain a court order authorizing the nonconsensual use of cash collateral. This often translates into an opportunity for the secured creditor to negotiate and obtain advantageous rights and concessions in exchange for allowing the debtor to use its cash collateral.

To use cash collateral (either consensually or nonconsensually), a debtor must demonstrate that the secured creditor's interest in the collateral is adequately protected. To the extent a secured creditor suffers due to a decline in the value of its collateral during the bankruptcy case as a result of the imposition of the automatic stay or the debtor's use of such collateral during the case, the secured creditor may assert an adequate protection claim against the debtor, which claim is granted superpriority status under Section 507(b) of the Bankruptcy Code.

The calculation of an adequate protection claim was at the heart of a dispute between Residential Capital LLC and its affiliated debtors (collectively, the "debtors") on the one hand, and the indenture trustee, the collateral agent, and an ad hoc group of the debtors' junior secured noteholders (collectively, the "JSNs"), on the other hand, in *In re Residential Capital LLC* (Case No. 12-12020) ("ResCap"), pending before Judge Martin Glenn in the Bankruptcy Court for the Southern District of New York.

At the commencement of the ResCap case, the debtors and the JSNs reached an agreement regarding the consensual use of cash collateral, and the court entered an order (cash collateral order) specifying, inter alia, that the debtors may use the JSNs' cash collateral in accordance with an approved budget.

In return, the JSNs received an adequate protection package consisting of (1) adequate protection liens on their existing collateral as well as on certain additional assets, (2) adequate protection payments in the form of professionals' fees for the indenture trustee and the ad hoc group, and (3) superpriority claims under Section 507(b) of the Bankruptcy Code. In particular, the cash collateral order provided that the JSNs were entitled to:

adequate protection of their interests in the prepetition collateral, including cash collateral, in an amount equal to the aggregate diminution in value of the prepetition collateral to the extent of their interests therein, including any such diminution resulting from the sale, lease or use by the debtors (or other decline in value) of any prepetition collateral, including cash collateral, the priming of [the debtor-in-possession lender's] liens on the [collateral] by the carveout and the [DIP loan], and the automatic stay pursuant to Section 362 of the Bankruptcy Code ....[1]

Notably, but not surprisingly, the cash collateral order did not set an initial value for the JSNs' collateral, nor did it specify a methodology by which the parties should value the collateral or calculate any diminution in the value thereof.

As the case proceeded, the JSNs claimed that they were oversecured creditors and asserted secured claims in the amount of \$2.22 billion, plus post-petition interest and fees — a position vehemently opposed by the debtors and the official committee of unsecured creditors.

Accordingly, the debtors and the committee (together, the "plaintiffs") commenced adversary proceedings (which were subsequently consolidated) to determine the validity and extent of the JSNs' liens and for declaratory relief that the JSNs were not oversecured.

One of the primary arguments made by the JSNs in support of their argument that they were oversecured is that they were entitled to an adequate protection claim as a result of the debtors' use of their cash and noncash collateral during the case.

Specifically, the JSNs initially argued that they were entitled to an adequate protection claim in an amount equal to each dollar of the JSNs' cash collateral used by the debtors during the bankruptcy case, notwithstanding that the debtors were using such cash pursuant to the cash collateral order.

As a result, the JSNs brought counterclaims seeking, inter alia, a declaration that the debtors' use of cash collateral results in a per se diminution of the collateral's value, and that the debtors' waiver in the cash collateral order of their rights under Section 506(c) to surcharge the JSNs' collateral prevents the debtors from allocating expenses to the JSNs under the budget without compensating the JSNs for such use through an adequate protection claim.

On consideration of the plaintiffs' motion to dismiss these counterclaims, the court rejected the JSNs' "dollar-for-dollar" theory, holding that "not every use of cash collateral constitutes a per se diminution in the value of the JSNs' collateral." [2] Indeed, "since the court has found that the JSNs are adequately protected so long as the debtors only use cash collateral pursuant to the cash collateral order, 'by definition, there is no surcharge and Section 506(c) does not come into play.'" [3] In a later decision, the court further noted that:

[w]here cash collateral use is permitted according to an approved budget, and the cash collateral order includes a Section 506(c) waiver, the two provisions work in tandem. Unless the remaining value of the cash and noncash collateral at the effective date falls below the value of the collateral on the petition date, the creditor is not entitled to compensation for the amount of cash collateral spent under the approved budget.[4]

Thus, the bankruptcy court made clear that at trial, the issue would be whether the JSNs suffered a diminution in the value of their collateral between the petition date and the effective date of the debtors' Chapter 11 plan. While there was no substantial dispute regarding the value of the collateral as

of the effective date (putting aside certain disputes regarding the extent of the JSNs' liens), the parties hotly contested the valuation methodology to be employed when calculating the value of the collateral as of the petition date.

Following a lengthy trial and various submissions by each of the parties, the court found that the JSNs were not entitled to any adequate protection claim. In reaching this conclusion, Glenn made several key rulings, which, as discussed below, can provide valuable lessons in drafting cash collateral orders or dealing with disputes on adequate protection claims.

First, the court recognized that the "burden of proving valuation falls on different parties at different times."<sup>[5]</sup> The secured creditor initially bears the burden of establishing the amount and extent of its lien under Section 506(a) of the Bankruptcy Code. Once the amount and extent of the lien is established, if the debtor seeks the ability to use, sell or lease the secured creditor's collateral or cash collateral pursuant to Section 363 of the Bankruptcy Code, the debtor bears the burden of proving that the secured creditor's interest is adequately protected.

Thereafter, if the secured creditor seeks to assert an adequate protection claim based on the alleged diminution in the value of its collateral during the bankruptcy case, the secured creditor again must bear the burden to establish the extent and validity of its claim under Section 506(a).<sup>[6]</sup>

Second, under the facts of the ResCap case, Glenn decided that the petition date value of the collateral should be calculated by using the fair market value of the assets in the hands of the debtors. In reaching this determination, the court began with the plain language of Section 506(a) of the Bankruptcy Code, which provides, in pertinent part, that the value of a secured creditor's claim "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."

Next, Glenn reviewed relevant case law interpreting Section 506(a), including the U.S. Supreme Court decision in *Associates Commercial Corp. v. Rash*,<sup>[7]</sup> and a more recent decision from the Eastern District of California in *Salyer v. SK Foods LP (In re SK Foods LP)*.<sup>[8]</sup>

In *Rash*, the debtors invoked the "cramdown" provision of Section 1325(a) of the Bankruptcy Code to confirm a Chapter 13 plan over the objections of a secured creditor and to keep the collateral for themselves. Notwithstanding that the debtors intended to keep the collateral, they argued that the proper valuation of the collateral was foreclosure value.

The Supreme Court disagreed, finding that "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question" and therefore, that the proper valuation methodology in that case was the replacement value of the collateral.<sup>[9]</sup>

Glenn similarly found the reasoning persuasive in *SK Foods*, where the District Court for the Eastern District of California held that the bankruptcy court properly applied a liquidation value for those assets that were to be liquidated and a going concern value for those assets that were to be sold as part of a going concern business.<sup>[10]</sup>

Applying these principles to the ResCap case, Glenn found that the petition date valuation must account for the proposed disposition of the collateral. In ResCap, that was the fair market value of the assets in the hands of the debtors as of the petition date because the testimony at trial indicated that the debtors did not intend to return the collateral to the collateral agent, the JSNs did not foreclose or attempt to foreclose on the assets, and the parties at all times anticipated a sale of the assets as part of a going

concern business.

At trial, the JSNs sought to establish the fair market value of their collateral as of the petition date under this standard, but the court did not find their valuation credible.

First, Glenn held that the JSNs incorrectly assumed that the collateral actually could have been sold by the debtors on the petition date. Instead, the evidence reflected that, due to the nature of the collateral (which included, among other things, mortgage loans and mortgage servicing advances), the debtors could not have sold the collateral absent the consent of certain interested parties and governmental entities.

These consents were achieved only after the debtors spent months post-petition negotiating the payment of hundreds of millions of dollars to such parties, and the settlement of billions of dollars of alleged liabilities associated with the assets.

Second, the court held that the JSNs failed to consider the comparable sales prices of “other distressed entities on the brink of insolvency.”[11] Instead, they focused their analysis on the potential sale price of the assets in the hands of a solvent company, “ignor[ing] the reality of the period leading up to this bankruptcy: ResCap was an insolvent company, overburdened with debt, owning assets that had to be ‘fixed’ before they could be sold, and facing a real possibility of being shut down.”[12]

Because the JSNs failed to properly value their collateral as of the petition date, they were unable to carry their burden of proving a diminution in the value of the collateral over the course of the case and, thus, the adequate protection claim failed.

The ResCap cash collateral order is not unique in its general ambiguity as to how or when an adequate protection claim is calculated. Indeed, a canvass of approved consensual cash collateral orders in recent large bankruptcy cases suggests the rarity (even nonexistence) of preordained methodologies for valuing collateral for the purpose of calculating an adequate protection claim.

While the advance negotiation of these adequate protection issues may be difficult to impossible depending on the circumstances of the case, the lack of concrete, agreed-upon guidelines to value collateral and calculate any decline in the value thereof can present serious problems for secured creditors when asserting adequate protection claims.

Thus, as discussed below, parties should strive to obtain as much precision as possible and memorialize those terms in a clear and complete consensual cash collateral order.

### **Practice Points: Considerations for Debtors and Secured Creditors**

Counsel for debtors and secured creditors should consider including provisions in the cash collateral order specifying the beginning and end dates for calculating an adequate protection claim, and the collateral value — or at a minimum, the standard for calculating the collateral value — as of such dates.

Potential values or methodologies may include:

- (1) the liquidation value, if the parties anticipate a fire sale or liquidation of the collateral;
- (2) the stalking horse bid value, if applicable; or

(3) asset values from recent sales of comparable assets by similarly situated distressed companies.

While the “dollar-for-dollar” theory made little sense in ResCap, there are situations where each dollar of cash collateral spent could result in a per se diminution in value (e.g., where the cash collateral spent has little to do with the preservation or sale of the collateral). In such cases, the secured creditors would be wise to either seek such amounts back in the form of adequate protection payments, or specify such methodology as the basis for calculating their adequate protection claim.[13]

The parties should also consider upfront whether the assets realistically can be sold as of the initial date or if adjustments to value need to be made to account for serious impediments to the immediate sale of the assets.

Finally, counsel for the debtor or creditors’ committee should make sure to clarify in the cash collateral order that (1) use of cash collateral is in exchange for, and does not violate, the Section 506(c) waiver, if applicable, and (2) any adequate protection claim relates only to a diminution in the value of the collateral in the aggregate.

Secured creditors will be more significantly impacted by the failure to agree to the collateral value or valuation methodologies in advance because they bear the burden of proving their adequate protection claim. However, debtors could likewise benefit from this clarity because advance agreements can obviate the need for time-consuming and costly litigation on these issues.

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[1] Case No. 12-12020, Docket No. 491, ¶ 16.

[2] Case No. 13-01343, Docket No. 22, at 28.

[3] Case No. 13-01343, Docket No. 22, at 25-25. The court adopted the reasoning set forth in *In re Pro Alert LLC*, 314 B.R. 436 (B.A.P. 9th Cir. 2004). “The ProAlert court explained that ‘§ 506(c) is concerned with an entirely different conflict than that addressed by § 363,’ and noted the absurdity that would result if a debtor must satisfy Section 506(c) in connection with any use of cash collateral ....”

[4] Case No. 13-01343, Docket 177, at 71.

[5] Case No. 13-01343, Docket 177, at 60.

[6] *Id.*

[7] 520 U.S. 953 (1997) (“Rash”).

[8] 487 B.R. 257 (E.D. Cal. 2013) (“SK Foods”).

[9] *Id.* at 962.

[10] 487 B.R. at 262.

[11] Case No. 13-01343, Docket 177, at 70.

[12] *Id.*

[13] See, e.g., *In re ProAlert LLC*, 314 B.R. 436, 439 (affirming the bankruptcy court’s decision to allow the debtor to pay two professionals on the condition that the debtor must replenish such funds, on a dollar-for-dollar basis, by a certain specified date as an additional type of adequate protection payment).