Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10169 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Ch. 11 Lenders Are Flexing Their Muscles — At Their Own Risk

By **Emily Lever**

Law360 (September 26, 2023, 6:28 PM EDT) -- As the turbulent U.S. economy has left more companies deep in distress by the time they seek bankruptcy, lenders have moved in to take advantage, playing on debtors' desperation for asset sales as they try to stay in business, but exposing them to risks — including the ire of judges.

Debtor-in-possession lenders and stalking horse bidders are tightening their grip on debtors, using unorthodox bidding processes and strategically underfunding cases to get a better deal for the debtors' assets, among other tactics.

U.S. Bankruptcy Judge Karen B. Owens called out the tactic in an Aug. 21 final DIP hearing for cancer treatment equipment maker ViewRay, in which DIP agent and lender MidCap Financial Trust pushed for it to secure a stalking horse bidder in less than a week or else default on its $9 million loan.

"We've been seeing in this court recently extraordinary attempts to modify the fundamentals of the DIPs and the sales processes," Judge Owens said. "My colleagues are pushing back on every single one. It's really been an extraordinary time period that has caused us to give it serious thought to what is happening in our cases."

The bankruptcy bar has seen similar lender-debtor dynamics in past downturns, but the current cycle is exacerbated by high interest rates coupled with more aggressive actors than in past decades, according to Chris Ward, the head of Polsinelli PC's restructuring practice.

"We're in a really tight economy with rising interest rates, and some lenders, especially private equity lenders, are getting more aggressive to protect their collateral," he told Law360.

Judges are tasked with preserving the integrity of the bankruptcy process while also trying to stabilize the "quickly melting ice cube" of companies hemorrhaging money, and lenders are using that tension to their advantage, according to Ted Gavin of Gavin Solmonese LLC.

Knowing that judges are willing to approve arrangements they might otherwise deny if jobs are at stake and the debtor is at risk of collapsing, lenders can underfund cases to ensure the debtor is in dire enough straits to drive the judge to approve a less-than-ideal sale process, according to Gavin.

If creditors believe that preserving jobs will tip the scales for a judge, then putting going-concern value in danger can help ensure they can engineer the sale process to snap up the debtor's assets, he said.

"Once there is a set of circumstances allowing deviating from what the debtor is supposed to do, the lenders can orchestrate those circumstances in order to get the timeline that they want," Gavin said. "What starts out as exigent circumstances becomes routine."

While a rushed sale is what drew criticism from Judge Owens, it was a stalking horse that refused to serve as the backup bidder that upset U.S. Bankruptcy Judge Brendan Shannon during an Aug.

18 hearing in Delaware.

In the Chapter 11 for Williams Industrial Services Group, Judge Shannon was "flummoxed," telling stalking horse bidder Energy Solutions that judges were noticing sales and DIPs "moving in a direction that is not welcome."

Those kinds of remarks from judges signal that they feel lawyers have gone too far in trying to get a good deal for their client, according to Anthony Sabino, a creditor-side attorney and a law professor at St. John's University.

"Maybe you don't think you're pushing hard, but if the judge has that impression of you, you may also be damaging your credibility with the court," he said. "If the judge is giving you a funny look and saying, 'Hey! The timeline is too short,' you walked into that particular bear trap."

Debtor Distress

Lenders weren't always so comfortable flexing their muscle. In the 1980s and 1990s, the norm was for lenders to tread much more lightly, according to Nancy Rapoport, a law professor at the University of Nevada, Las Vegas.

"Lenders were nervous about exerting too much control," she said. They risked being accused of trying to act as if they were the debtor, she added.

But lenders are winning assurances now in part because companies are hitting bankruptcy in deeper financial turmoil, unlike some previous similar cycles, according to Gavin.

"The later a company is in its distress, the fewer options it's going to have, and the lenders are getting more and more fatigued with getting strung along and strung along," Gavin said. "They become more strident in their reactions to anything adverse. The debtor becomes much more fragile, so the lender becomes more wary."

Lenders are also demanding more input than they did 20 years ago because of the consolidation of post-petition financing, according to Gavin. Instead of a loan with multiple tranches held by multiple parties, it's more common to have one hedge fund for an entire capital stack, he said.

"The days are over where a lender would just write a check and shut up," Gavin said.

Debtor Comebacks

Lender power has its limits, however. In addition to potentially angering judges by being too aggressive, creditors also don't want to push so hard that they get saddled with assets that are difficult to offload in a stressed economy.

During a downturn, debtors have leverage over their creditors because they can force them to accept either a partial recovery or a non-performing asset, according to Sabino. For example, a bankrupt real estate company with heavily-mortgaged buildings could exploit its leverage over the banks holding those mortgages because ending up saddled with the buildings would be an unappealing option in this economy.

"This could be the best time to file Chapter 11. The banks' blood pressure would go through the roof, but then what are they going to do?" Sabino said, referring to lenders. "If you don't agree to this haircut, you're stuck with this [asset]."

Debtors' best defense may be to play offense by sorting out as much of the bankruptcy as they can before the petition to give creditors less room to maneuver, according to Douglas Baird, a law professor at the University of Chicago Law School and chair of the National Bankruptcy Conference.

"The name of the game is prebankruptcy period liability management exercises: extending runway, giving the debtor additional time to file a plan of reorganization," he said. "You want to

make the bankruptcy as prearranged as possible."

The timing could also be right for a revival of lender liability, meaning that a lender can be found to have so much control over a borrower that it is running the borrower's company and thus has a fiduciary responsibility to it.

Lender liability arose in the 1980s and 1990s but has been rare, Rapaport said. It could make a comeback if judges can be convinced it's warranted, she said.

In a rare recent example of the theory's use, the U.S. Bankruptcy Court for the Northern District of Texas imposed lender liability in 2021, albeit on a bridge lender in a failed restructuring that culminated in a bankruptcy.

Borrower Bailey Tool & Manufacturing Co. successfully sued former lender Republic Business Credit LLC to impose lender liability. The court found Republic had "grossly interfered" in Bailey's business to the point of driving it into Chapter 11 bankruptcy and then a Chapter 7 liquidation. Republic's tactics included trying to oust Bailey's leadership and employing its own armed guards at Bailey's facilities as an intimidation tactic, the court found.

Republic was hit with an $18 million judgment. But even less extreme interference can potentially trigger lender liability, leading to a lender recovering nothing at all and maybe even paying penalties, Rapoport said.

"Debtors' lawyers absolutely should dust off their old lender liability briefs, because the more control the creditors ask for, the more they're helping to run the debtors' businesses," she told Law360.

But debtors may not be in a position to bring up lender liability themselves because of how beholden they are to the lender, Ward said.

"It's more realistic that it's going to be an unsecured creditors' committee or a U.S. trustee that's going to raise those issues," he said.

The future of this new debtor-creditor dynamic is ultimately in the hands of judges, who must be willing to assume the risk of nixing a deal that is too restrictive, according to Baird.

"The judge has a Hobson's choice: Either accept the unfavorable terms and see a clear path to reorganization, or the judge can push back and be told, 'There's a chance we're not going to be able to make payroll,'" he said.

"The next big challenge in bankruptcy is for judges to figure out how to play this game of chicken."

--Editing by Adam LoBelia.

All Content © 2003-2023, Portfolio Media, Inc.