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Is Silence Golden?

Shareholder's Arsenal Aided in LBO Wars

By Michael J. Sage & Derek M. Johnson

BY DECLINING to hear a debtor's appeal, the U.S. Supreme Court may have made it significantly more difficult for debtors to recover payments made to selling public shareholders in leveraged buy-out (LBO) transactions. See *Kaiser Steel Corp. v. Pearl Brewing Co.* (*In re Kaiser Steel Corp.*), 952 F.2d 1230 (10th Cir. 1991) (*Kaiser II*), *cert. den.* June 22, 1992.

Although LBOs may be structured in many different ways, there is a common format: A management/investor group decides to purchase a target company. The same group sets up a thinly capitalized shell company. The shell company then borrows sufficient funds from an LBO lender to purchase the stock held by the target company's shareholders. The loan is secured by a lien on the target's assets. After the shares are purchased, the management/investor group causes the shell company and the target company to merge, and the new entity assumes the LBO indebtedness. The net effect is that the target's equity has been replaced with debt, and the ownership has shifted from the former stockholders to the management/investor group.

The management/investor group in most LBO transactions bets that it will be able to generate sufficient income to service the LBO debt, enjoy tax advantages by deducting interest payments and gradually de-leverage the company. As has become common knowledge, however, servicing the prodigious LBO debt is often much more difficult than expected, particularly during an economic downturn. Consequently, many of the former LBO targets have found themselves in bankruptcy court, as Chapter 11 or Chapter 7 debtors.

Once in bankruptcy court, the highly leveraged debtors (or their court-ap-

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Contrary to Code:

Cross-Collateralization Provision Invalidated

By Adam L. Rosen

THE U.S. Court of Appeals for the Eleventh Circuit has become the first such court to invalidate a cross-collateralization provision in a debtor-in-possession financing agreement, making it less likely that lenders will be as cooperative in providing assistance to troubled companies. *Shapiro v. Saybrook Manufacturing Co.* (*In re Saybrook Manufacturing Co.*), No. 91-8542 (June 25).

The Eleventh Circuit held that cross-collateralization could not be authorized because (1) it is not a permitted method of postpetition financing under Bankruptcy Code Sec. 364, and (2) "it is directly contrary to the fundamental priority scheme of the Bankruptcy Code" and may not be approved by a bankruptcy court under its equitable powers.

In addition, the court held that the motions provision contained in Sec. 364(e), which protects good faith lenders, does not prevent reversal on appeal because that protection only applies to properly approved financing orders and the Bankruptcy Court's order was improper because cross-collateralization is not authorized by Sec. 364.

Past Approval Reluctant

Cross-collateralization is a postpetition financing arrangement whereby a debtor obtains a postpetition loan and, as part of the transaction, secures a prepetition debt with prepetition and/or postpetition collateral. In *Otte v. Manufacturers Hanover Commercial Corp.* (*In re Texlon Corp.*), 596 F.2d 1092, 1094 (2d Cir. 1979), a case decided under the Bankruptcy Act, the Second Circuit was one of the first appellate courts to consider cross-collateralization. While frown-

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ing on its practice, the court refused to condemn it outright. Instead, it held the cross-collateralization provision could not be granted ex parte.

Since *Texlon*, the issue of whether to permit this type of financing has been controversial and unsettled. Although cross-collateralization has been approved by several bankruptcy courts, those courts have done so reluctantly. See, e.g., *McLemore v. Citizens Bank (In re Tom McCormick Enterprises, Inc.)*, 26 B.R. 437, 439-40 (Bankr. M.D. Tenn.), *aff'd*, 32 B.R. 992 (M.D. Tenn. 1983); *In re Beker Indus. Corp.* 58 B.R. 725 (Bankr. S.D.N.Y. 1986).

The opportunity for cross-collateralization arises because postpetition lenders often are also prepetition lenders of the debtor in possession. These lenders sometimes will attempt to enhance recovery on their prepetition claims or decrease the prepetition undersecured deficiency on those claims by seeking to secure them with prepetition and/or postpetition collateral as part of the financing transaction.

Inconsistent Advantage

In effect, this raises the cost of postpetition loans by giving the postpetition lender a greater recovery than it would otherwise receive on its prepetition claim. Most courts that have considered the issue have concluded that giving such an advantage to a creditor's prepetition claim is inconsistent with the established principle that all prepetition creditors of the same type should be treated equally.

A number of courts, however, have approved cross-collateralization provisions where sound business reasons weigh in their favor to further the rehabilitative goal of Chapter 11. See, e.g., *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983) (holding that cross-collateralization would be permitted where: (1) the proposed financing is necessary for the debtor's survival; (2) there is no acceptable alternative financing; (3) it is the best deal possible; and (4) it is in the best interest of creditors); *General Oil Distrib., Inc.*, 20 B.R. 873 (Bankr. E.D.N.Y. 1985) (permitting cross-collateralization).

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Saybrook

In *Saybrook*, the debtors filed a motion for use of cash collateral and authorization to incur secured debt the day after they filed their Chapter 11 case. On the date the case was filed, the debtors owed Manufacturers Hanover Trust Company approximately $34 million. The value of the collateral securing this debt, however, was less than $10 million.

The bankruptcy court entered an emergency financing order pursuant to which Manufacturers agreed to loan the debtors an additional $3 million, but only if its prepetition *and* postpetition loans would be secured by all of the debtors' prepetition and postpetition property.

This, in effect, would secure the $3 million postpetition loan and a portion of the approximately $24 million of prepetition unsecured debt and enhance Manufacturers' position compared to other unsecured creditors. If the debtors' assets were liquidated, Manufacturers' entire debt, $34 million prepetition and $3 million postpetition, would have to be paid in full before any funds were distributed to unsecured creditors.

The Bankruptcy Court overruled the objection of two creditors, Seymour and Jeffrey Shapiro, to the entry of the financing order and refused to stay its order pending appeal. The District Court denied the Shapiros' motion for a stay pending appeal and dismissed the appeal as moot under Sec. 364(e). The Shapiros appealed to the Eleventh Circuit.

Manufacturers argued that the appeal of the Bankruptcy Court's order approving the financing arrangement was moot under Sec. 364(e) because that section provides that a lien or priority granted under Sec. 364 may not be overturned unless it is stayed pending appeal, and the Shapiros did not obtain such a stay.

Alternatively, Manufacturers argued that even if the appeal was not moot, the Shapiros were not entitled to relief because cross-collateralization is a legitimate means by which debtors can obtain necessary financing and it is not prohibited by the Bankruptcy Code. The *Saybrook* court rejected both arguments.

Mootness

The Eleventh Circuit held that the mootness provision contained in Sec. 364(e) does not prevent reversal on appeal because the financing order was not properly authorized under Sec. 364. Sec. 364(e) provides:

"The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal." 11 U.S.C. Sec. 364(e).

The *Saybrook* court stated that "the purpose of this provision [Sec. 364(e)] is to encourage the extension of credit to debtors in bankruptcy by eliminating the risk that any liens securing the loan will be modified on appeal."

Nevertheless, the court held that because approval of the objectionable provisions of the financing ar-

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rangement was not within the authority of the Bankruptcy Court in the first place, the order remained subject to appeal even without a stay.

Facing the Issue

Earlier courts of appeals had avoided directly deciding the appropriateness of cross-collateralization by holding that an appeal from a Sec. 364 financing order was moot without a stay. See, e.g., *Burchinal v. Central Washington Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484 (9th Cir. 1987); and *Unsecured Creditors Committee v. First National Bank & Trust Co. (In re Ellingsen MacLean Oil Co.)*, 834 F.2d 599 (6th Cir. 1987), *cert. denied*, 488 U.S. 817 (1988).

The Eleventh Circuit refused to follow that line of cases and determined it could not decide whether the appeal was moot under Sec. 364(e) until it decided the issue of whether cross-collateralization was proper.

Secs. 364 and 105

The Eleventh Circuit held that cross-collateralization was not authorized by Sec. 364 and noted that, had the financing been arranged prepetition within the preferenced period, the lien granted would have been avoidable under Sec. 547.

Manufacturers argued that even if cross-collateralization is not authorized by Sec. 364, bankruptcy courts may permit it pursuant to their general equitable powers under Sec. 105. The Eleventh Circuit rejected this argument, stating that although bankruptcy courts are courts of equity, their equitable powers are limited by the parameters of the Code.

Also, the court noted that the priority scheme set forth in Sec. 507 is designed to treat equally creditors within a given class and that courts are not permitted to create their own rules of priority within a single class. *Id.* at 9 (citing 3 *Collier on Bankruptcy* ¶ 507.02[2] (15th ed. 1992)).

The court concluded that allowing a bankruptcy court to create its own rules of priority within a class of claims and, in effect, subordinate the claims of creditors within a class without the requisite showing of inequitable conduct, was not justified.

What to Expect

Presumably, bankruptcy courts in the Eleventh Circuit will no longer approve cross-collateralization financing arrangements and courts in other circuits will be less likely to do so, thus preventing lenders from insisting on such a provision. It should be noted that granting a lender a security interest in prepetition and/or postpetition collateral to secure a postpetition loan is not cross-collateralization as defined and prohibited by *Saybrook*.

As an alternative to cross-collateralization in cases involving collateral that is inventory or receivables, the lender may require, as part of the postpetition financing transaction, that the debtor repay its prepetition secured debt as the collateral securing such debt is collected or utilized. This would require nothing more than the payment of cash collateral to a secured creditor for application to prepetition debt and does not appear to be prohibited by *Saybrook* or the Bankruptcy Code.

Saybrook will concern postpetition lenders because the court made the protection of Sec. 364(e) contingent upon a proper determination that the financing was authorized under Sec. 364. Thus, lenders will have to take care to be sure that financing transactions they enter into are within the ambit of Sec. 364.

Business Failures Increase 17%

BUSINESS FAILURES increased 16.8 percent to 50,582 in the first half of 1992, from 43,324 in the same period of 1991, according to an analysis performed by The Dun & Bradstreet Corp.

With the exception of the mining sector, every major industry group reported an increase in business failures in the first six months of 1992. The steepest increase was reported in the agriculture, forestry and fishing sector, up 33.2 percent to 1,542 reported failures. The services sector posted a 24.4 percent increase to 13,856. Eight of the nine U.S. Census regions reported increases in services bankruptcies, with the sharpest increases occurring in the Middle Atlantic and Pacific regions. Services failures in the Mid-Atlantic states soared 45.3 percent in the first six months of 1992; similar failures in the Pacific states increased at almost the same pace, up by 44.7 percent.

Finance, Insurance and Real Estate Sector Also Up

The finance, insurance and real estate sector continues to report increases in business failures. For the first six months of 1992, failures rose 17.1 percent to 3,230. The sharpest increases were reported in the Pacific region, up 57.3 percent; closely followed by the New England states, up 44.4 percent; and the Mid-Atlantic states, up 36.5 percent.

Wholesale and retail trade failures also increased across the county. Overall, wholesale trade failures climbed 20.9 percent, with the Mid-Atlantic and Pacific regions reporting the highest increases. Retail trade failures increased 16.6 percent in the first half of 1992.

Manufacturing failures increased 18.1 percent, with the steepest increases again reported in the Mid-Atlantic and New England states. Construction failures increased 12.9 percent. Two industries, transportation and public utilities, reported only a slight increase in failures, up by a combined 3 percent. Mining failures were down slightly, about .5 percent.