Bankruptcy Law

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A legal update from Shumaker, Loop & Kendrick, LLP | **October 2011**

Setoff: A 100% Solution

Prior to the economic downturn, when a customer filed for Chapter 11, creditors realistically thought in terms of being paid 100% of their pre-petition claims. This was without regard to remedies such as "critical vendor", "20-day administrative claim" or even the reclamation claim. Creditors could be paid 100% simply because the distressed customer had the ability to survive in Chapter 11, exit Chapter 11 and consummate a business plan that included payment of 100% of pre-petition claims. To be sure, there have been many "10 cent" plans, but "100 cent" plans did happen.

Unfortunately, the landscape has materially changed in the last few years, as the value of business assets have materially declined and operating performance has deteriorated. More frequently, the business assets that were pledged to lenders as collateral for working capital loans have market values that are less than the loans owed. Moreover, the customers' deteriorating operating performances result in greater loan covenant violations, or the inability to operate without being in breach of loan agreements.

In these situations, when a formal insolvency proceeding occurs, all too often the end result is the lender takes a "haircut" and the other creditors are "out of the money". Usually, this occurs pursuant to some form of a Section 363 sale of all of the customers' assets to those cash rich buyers looking for a good deal.

How then can a creditor get paid, much less 100%, in such situations? One reliable method has been through the remedy of SETOFF. An ancient remedy going back to at least the Romans, setoff is the simple concept of setting off accounts to achieve economic efficiency. A owes B $100, B owes A $50. Rather than A pay B $100, then in a second transaction B pay A $50, A simply pays B $50, and the accounts are settled.

The Bankruptcy Code preserves this ancient remedy in Section 553, which provides:

> … this title (Chapter 11) does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case … against a claim of such creditor against the debtor that arose before the commencement of the case.

Setoff rises to the level of a secured claim under Section 506 of the Bankruptcy Code which provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, OR THAT IS SUBJECT TO SETOFF UNDER SECTION 553 (emphasis added) of this title, is a secured claim to the extent of … the amount subject to setoff ….

This means in the AB example above, A would be a secured creditor to the extent of $50 and an unsecured creditor for the remaining $50. In effect, A receives 100% of its setoff claim.

However, there have been recent cases where creditors' setoff rights have been SUBORDINATED to the lenders' claims pursuant to a DIP (debtor in possession) financing order. In an era where lenders' claims are often equal to or less than the value of their collateral, being subordinated means being wiped out. How does this happen?

The Bankruptcy Code allows a debtor to borrow money in a Chapter 11. In cases where the debtor is not able to borrow money except on a senior lien basis, the Bankruptcy Code allows a DIP lender to "prime", or come ahead of, existing liens, provided existing liens are "adequately protected". Lenders have included in DIP financing orders provisions which not only subordinate existing liens but also setoff rights to the new liens granted in the DIP loan. This is despite the fact that the Bankruptcy Code only provides for priming of "liens", nothing else. Arguably, expanding the scope of the priming lien to setoff rights is not permitted by the Bankruptcy Code. Lenders have argued that while setoff rights are not technically liens, they are treated as secured claims and should be subject to priming just as liens are.

Since DIP loan orders are usually entered on a "first day motion" basis, often there is no opposition to such provisions. Bankruptcy Courts usually approve unopposed motions as presented. Holders of setoff rights argue that the Bankruptcy Code simply does not provide for priming of setoff rights, and courts have no authority to change that. As a practical matter, once a DIP financing order becomes final, it is virtually impossible to change it. Accordingly, a creditor with a setoff right must object to the first day DIP motion if it purports to prime setoff rights, in order to preserve this "100 cent" remedy.

Subordination of setoff rights is another aspect of Chapter 11 cases that illustrates the tension between secured lenders and other creditors, each attempting to maximize recovery on their respective claims.

We hope you found this information helpful. If you have any questions regarding the foregoing, or any other matter, please feel free to contact us.

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October, 2011