Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

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VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Legal Opinions in Commercial Finance

UCC SUBCOMMITTEES AND TASK FORCES

- Consumer and Commercial Contracts

Joint Report from the Chairs

Dear Members:

As a reminder, the ABA Business Law Section's Virtual Section Annual Meeting starts on Wednesday, September 22, 2021. There is still time to register (it is free for ABA BLS members). Both the UCC and Commercial Finance Committee have some very interesting and informative CLE programs as well as Subcommittee meetings. You can still register here: https://web.cvent.com/event/ca7ad530-c927-42be-a4cf-1c77e8ad9577/regProcessStep1. We will also be holding the Joint UCC/ComFin Virtual Reception on September 24, 4:30 – 5:30 pm central.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

We hope you enjoy this issue, and invite you to get involved in your committee(s). We hope to see you (virtually) at the annual meeting.

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Featured Articles

Key Developments in the USD LIBOR Transition: Alternative Reference Rates Committee Formally Recommends Term SOFR and Releases Recommended Best Practices and Conventions for Use of SOFR Term Rates in Contracts

By Jennifer Wasylyk, Cassels Brock & Blackwell LLP

On July 29, 2021, the Alternative Reference Rates Committee (ARRC), the working group backed by the United States Federal Reserve and tasked with recommending a replacement for US dollar (USD) LIBOR, formally recommended the CME Group's forward-looking Secured Overnight Financing Rate (SOFR) term rates (SOFR Term Rates) for one-, three- and six-month tenors. This is a major milestone in the transition away from US LIBOR.

This announcement follows completion of the first phase under the SOFR First initiative, which commenced on July 26, 2021 and recommended that financial institutions switch from USD LIBOR to SOFR for all linear swap trades in the interdealer market. That switch boosted overnight SOFR-linked derivatives volumes, which was a market indicator that the ARRC said they would consider in recommending SOFR Term Rates.

The formal recommendation of SOFR Term Rates by the ARRC is expected to boost the switch from USD LIBOR to SOFR Term Rates.

For new business loans which incorporate a reference rate, the ARRC recommends using SOFR Term Rates or another SOFR-based rate.

For existing business loans with USD LIBOR exposures, and given that there have been several iterations of the ARRC's fallback language (including an initial "amendment approach" which was adopted in many contracts early on in the LIBOR replacement process), parties should review documentation that references USD LIBOR to determine the extent of the fallback language included therein (if any) and whether any amendments are required and/or recommended.

- **No fallback language:** Contacts that do not contain fallback language should be amended to either (a) incorporate the ARRC's recommended "hardwired approach" fallback language or (b) replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) or another SOFR-based benchmark replacement.
- **Amendment approach fallback language:** Where contracts contain the ARRC's "amendment approach" fallback language, parties should consider either (a) amending to incorporate the ARRC's recommended "hardwired approach" fallback language or (b) utilizing the amendment process set out therein to replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) or another SOFR-based benchmark replacement.

- **Hardwired approach fallback language:** For contracts that contain a form of the ARRC's "hardwired approach" fallback language, USD LIBOR will be automatically replaced with the ARRC-recommended SOFR Term Rates (plus applicable spread adjustment) on the earlier of (a) the cessation of USD LIBOR, (b) USD LIBOR being declared to no longer be representative and (c) an early-opt in election by the relevant parties. Parties should continue to monitor updates in the transition from USD LIBOR to SOFR, and periodically consider whether they want to make an early opt-in election to replace USD LIBOR with SOFR Term Rates (plus applicable spread adjustment) in advance of the cessation of USD LIBOR or USD LIBOR being declared to no longer be representative.

Parties should also review existing documents to determine if the ARRC's recommended SOFR conventions should be incorporated. On July 21, 2021, the Alternative Reference Rates Committee (ARRC) released recommended best practices for use of forward-looking secured overnight financing rate (SOFR) term rates (SOFR Term Rates) in contracts, as well as recommended conventions for both SOFR Term Rates and SOFR averages.

Although the use of SOFR Term Rates will not be appropriate in all circumstances, the ARRC continues to support the use of SOFR Term Rates for business loans. In addition to SOFR Term Rates, parties in business loans may choose to use one of several other SOFR-based rates.

In preparation for a switch to a SOFR-based rate, the ARRC has recommended certain loan conventions. Where USD LIBOR is replaced with SOFR Term Rates, many of the loan conventions are similar to LIBOR loan conventions, given that the interest rate is known in advance of the interest period. Such conventions include:

- **Rate Publication Calendar and "Business Day" conventions:** "Business Day" should be defined to align with the rate-publication calendar for SOFR and payments scheduled to be made on non-Business Days should be adjusted to the next-succeeding Business Day (or, if the next-succeeding Business Day falls in the next calendar month, the immediately-preceding Business Day).

- **Temporary Unavailability of Rate:** Documentation should include a temporary fallback convention to address situations where the relevant SOFR-based rate (or relevant tenor thereof) is not published for a short period of time.

- **Lookback:** The applicable rate should be the rate published two business days prior to the first day of the applicable interest period and held for the entirety of the interest period.

- **Borrowing Notice Period:** It is recommended that borrowers submit a borrowing request three business days prior to the borrowing date, similar to LIBOR convention.

- **Day Counts:** The ARRC recommends the use of a day count convention of Actual/360 days for SOFR Term Rates and SOFR averages, consistent with the standard convention in US money markets.

- **Compensation for Losses:** Consider including language that compensates lenders for funding losses (e.g., break fees resulting from intra-period prepayment and losses resulting from the failure to make borrowings or payments when due or scheduled).

- **Interest Rate Floor:** Parties should consider including an interest rate floor, noting that an existing floor for USD LIBOR would continue to apply where the ARRC's updated fallback language has been adopted.

- **Rounding:** SOFR Term Rates and SOFR averages will be published to five decimal places, as with LIBOR; as such, parties may consider using their current rounding practices.

- **Fallback Language:** documentation should include robust fallback language.

Given the rapidly approaching end to USD LIBOR, parties should continue to monitor updates and market shifts and assess whether amendments to loan documentation and other contracts are appropriate.

What's Market: 2021 Mid-Year Trends in Large Cap and Middle Market Loans

by Maria Barclay, Tim Fanning, and Stephanie Backes, Practical Law Finance

This Article, originally published on July 22, 2021, is a review of trends in large cap and middle market lending in the first half of 2021.

Following a rollercoaster 2020, the US leveraged loan market started 2021 strong as fears concerning the COVID-19 pandemic abated amid the launch of the vaccine rollout. Spurred by low interest rates, repricings and refinancings drove loan issuance in the beginning of the year, with new money deals picking up in the second quarter. Special purpose acquisition company (SPAC) and sustainability-linked loan activity surged and direct lending remained a strong part of the market. Loan agreement negotiations continued to include discussions regarding LIBOR replacement and EBITDA addbacks. Attention was also given to addressing technical matters, such as the consequences of erroneous payments by administrative agents to syndicate banks and event of default cure provisions, among others.

Market Trends and Developments

Last March, at the start of the COVID-19 lockdowns, the most pressing issue for many borrowers was the preservation of liquidity. As a result, borrowers drew down their revolvers to bolster their cash reserves and new loan issuances plummeted. The second quarter of 2020 was especially hit hard. The loan market began to stabilize in the latter half of 2020, however, and as economic growth accelerated alongside the steady rollout of vaccines, there was a surge in activity in the loan market across many sectors. A strong start to 2021 and a strongly rebounding economy has given market participants cause for optimism that this increased activity will continue through the end of 2021 and beyond.

Total US syndicated lending climbed to a healthy $710 billion in the first quarter of 2021, up 13% year-over-year. Levels jumped even higher in the second quarter, reaching $764 billion, more than double the $375.88 billion recorded in the second quarter of 2020.

Leveraged loan issuance increased to $655.8 billion in the first half of 2021, an increase of 63% from the same period last year. First quarter levels posted roughly $357.8 billion and although issuance dropped in the second quarter to $298 billion, this represented a 122% jump compared to the $134 billion posted in the second quarter of 2020.

Investment grade loan issuance reached $329 billion in the second quarter of 2021, an increase of 82% compared to the $180.5 billion posted during the same period last year. Second-quarter investment-grade M&A lending levels remained steady at $42 billion while investment-grade refinancings totaled $258 billion.

US collateralized loan obligation (CLO) activity was strong in the first half of 2021; new-issue volume reached $42.4 billion in the second quarter, up 10% from the first quarter, while CLO repricing activity totaled $134 billion in the first half of this year. According to data from JPMorgan, global CLO issuance is likely to exceed $1 trillion. The uptick in CLOs represents a change from last year when the pandemic led to a dramatic fall in issuance. Market watchers anticipate investors may flock to CLOs if newly-emerged concerns about inflationary pressures in the economy persist.

Covenant-lite loan issuance remains a strong part of the leveraged loan market. According to Debtwire Par, cov-lite deals accounted for 84% of institutional loan issuance in 2020. Market observers anticipate that borrowers with healthy balance sheets, especially those which successfully weathered the pandemic, will continue to negotiate flexible covenant packages in their loan documents for the foreseeable future.

Repricing and refinancing transactions comprised roughly 74% of leveraged loan issuance in the first quarter of 2021, according to the Fitch US Leveraged Finance Market Insight Report. Refinancings totaled approximately $184.7 billion in the first quarter and $79 billion in the second quarter. According to Debtwire, repricings surged to $122.8 billion in the first quarter. Repricing activity will likely remain elevated if the current low-interest rate environment holds and there is a shortage of new deals in the market. According to market participants, many borrowers are eager to reprice their loans and many issuers in deals where call protection still applies plan to do so as soon as the call protection expires.

New money loan issuance picked up in the second quarter of 2021 and topped $78.2 billion, contributing to a first half total of $155.5 billion, an uptick of 74% compared to the period through June 2020. M&A-related leveraged lending totaled $160.1 billion in the first half of the year ($93.8 billion for non-leveraged buyout (LBO) M&A transactions and $66.3 billion for LBO deals), an increase of 54% and 59% from the period through June 2020. According to market watchers, the leveraged loan market has recently experienced a push toward larger M&A financings. Sponsored leveraged loan activity posted $358.5 billion in the first half of the year ($292.2 billion for non-LBO transactions and $66.3 billion for LBO deals), an increase of 124% and 58% from the period through June 2020.

Market observers anticipate SPACs are also likely to push M&A activity higher in 2021 and beyond. SPACs comprised roughly 17% of the M&A market in the first quarter of 2021, totaling approximately $232 billion. Although SPAC issuance clocked in at $13 billion in the second quarter, a decrease of 87% according to data from Barclays, pending SPAC IPOS still make up a robust $71 billion of the current pipeline.

Dividend recap issuance surged to roughly $20 billion in the first quarter of 2021, a high not seen since 2016, according to data from S&P Global. Market watchers have observed investors turning to dividend payments as the economy rebounds and interest rates remain low. Private equity firms may face mounting political pressure to curb dividend re-capitalization issuance in the future. Some legislators, such as Massachusetts Senator Elizabeth Warren, have voiced concerns with the increasing number of firms funding dividends with debt proceeds and may support more regulatory oversight, though currently dividend recap activity remains undimmed.

Second lien loan issuance totaled $11.65 billion in the second quarter of 2021, marking the highest quarterly volume since the third quarter of 2018 and the highest first half of a year since 2014.

Middle market lending rebounded in the second quarter of 2021, posting $46.2 billion ($40.6 billion in large middle market deals and $5.6 billion in the traditional middle market). Issuance reached $76 billion through June 2021, an increase of 56% year-over-year.

Loan Terms

In addition to the usual commercial points of negotiation between borrowers and lenders, particular issues of note in the leveraged loan market during the first half of 2021 included:

Erroneous Payment Provisions

In response to the US District Court of the Southern District of NY's decision in the Revlon case (2021 WL 606167), many arrangers have started incorporating protective language in their credit agreements to address the consequences of accidental payments made by administrative agents to syndicate members.

The issue arose when the administrative agent under Revlon's credit agreement mistakenly wired to the bank group the full amount of all outstanding principal and accrued interest, instead of just sending each lender their interim interest payments. The agent was only expected to send approximately $8 million in interest payments but instead remitted more than $900 million to the bank group. Several lenders agreed to send back the principal they had mistakenly received (accounting for roughly $400 million), but the holders of the other $500 million refused. The District Court held that these lenders could keep the money they had received, citing the "discharge for value" defense, it ruled that because the lenders believed they were entitled to receive the funds and had no knowledge or notice that the payments were sent by mistake, they should not be required to return the money. The decision is currently on appeal.

The Loan Syndications and Trading Association (LSTA) published a Market Advisory and draft model form of an erroneous payment provision on March 19, 2021 (updated June 16, 2021). Under this form of provision, the administrative agent can demand repayment of any funds sent by mistake and lenders have a contractual obligation to return the amounts mistakenly paid. There are variations in provisions seen in the market. Some provisions include a claw-back cut-off date, after which the administrative agent is no longer able to demand the return of any payments erroneously sent. Although market data from Covenant Review suggests most credit agreements do not include a claw-back cut-off date, this may emerge as a point of negotiation between loan parties moving forward (for an example of a credit agreement amendment that includes an erroneous payment provision, see Eagle Materials Inc. sixth amendment to credit agreement and see also What's Market, Frontier Communications Holdings, LLC credit agreement summary for an example of a credit agreement that includes a claw-back cut-off date in the erroneous payment (revolving credit facility) provision).

Covenant Compliance

During the pandemic, many borrowers and lenders agreed to temporarily suspend the borrower's compliance with its financial covenants or make them less onerous. As a quid pro quo for financial covenant concessions, many parties added anti-hoarding provisions and minimum liquidity requirements to their credit documents, as well as tightening other negative covenants. Market watchers have observed an unwinding of these types of concessions for many borrowers as the economy has bounced back and many borrowers are able to meet their original financial covenant tests.

EBITDA Addbacks

Borrowers and sponsors continue to seek extended forward-looking periods during which they can make pro forma EBITDA addbacks for anticipated cost savings and other synergies. In some cases, borrowers have been able to successfully negotiate longer-than-normal periods into their credit agreements (for an example of a credit agreement with a 36-month look-forward period, see What's Market, Leslie's Poolmart, Inc. credit agreement summary).

Some borrowers, whose businesses were negatively impacted by the pandemic, negotiated addbacks for one-time, extraordinary expenses related to COVID-19, while in other deals expenses related to the pandemic were specifically excluded though covenant levels in many cases were reset to accommodate borrowers' depressed EBITDA numbers. Some credit agreements have also permitted addbacks for lost earnings due to COVID-19 though this remains rare (for an example, see What's Market, CPI CG Inc. credit agreement summary and see also What's Market, Atlas Intermediate Holdings LLC credit agreement summary for an example where losses directly related to the pandemic are permitted, but not lost revenue or profits).

Market participants have also observed adjustments for costs that are "reasonably foreseeable" for a specific period of time. Examples can include costs and expenses related to pandemic planning, relocation assistance, equipment for remote employees, and cleaning supplies and protective gear. Market watchers have also seen COVID-19 addbacks included in compliance certificates, even if these addbacks have not been incorporated in the EBITDA definition.

Autocure Provisions

Breaches of loan agreement financial covenants are generally not curable unless the loan agreement includes an equity cure right. The purpose of an equity cure provision is to enable a borrower's parent or sponsor to directly inject cash into the borrower that is used to improve the measure of the borrower's performance for purposes of its financial covenant ratios so as to rectify any financial covenant default.

In an auto-cure provision, borrowers can take action to remedy a default or event of default which is then deemed cured. The borrower can take this action at any time after the initial breach unless the lenders have voted to exercise remedies. The effect of an autocure provision means that borrowers, and more importantly sponsors, are not limited by the applicable cure period for the default and have more time to consider and take into account the lenders' next steps before committing to fund a covenant cure.

Auto-cure provisions, which have been found in several large unitranche documents, have raised concerns among lenders. According to market participants, the right to cure at any time places almost all the power in a sponsor's hands; sponsors are no longer required to put up any cash, can extend the default date indefinitely, and can choose to exit the negotiation table at any time.

Incremental Facilities

Borrowers continued to successfully negotiate permissive incremental loan facilities and weaken the scope of the most favored nations (MFN) provisions. Under MFNs, if the interest rate margin on an incremental loan is higher than that on the initial loan by more than a threshold amount, the interest rate margin on the initial loan is increased so that it is not more than a specified number of basis points less than the rate on the incremental loan. Although the MFN threshold amount has typically been set at 50 basis points (bps), practitioners have observed borrowers and sponsors increasingly negotiating higher threshold levels (for an example of a credit agreement with a 75 bps MFN, see What's Market, Petco Health and Wellness Company, Inc. summary and for an example of a credit agreement with a 100 bps MFN, see What's Market, Leslie's Poolmart, Inc. amended and restated credit agreement summary).

Parties also continue to negotiate MFN sunsets into their credit agreements, so that the MFN ceases to apply after a certain period after closing (for examples of credit agreements with MFN sunsets, see What's Market, PPD, Inc. credit agreement summary (six months), What's Market, WW International, Inc. credit agreement summary (12 months), and What's Market, Torrid LLC credit agreement summary (18 months)). It is also common for MFN protection to exclude certain categories of incremental debt, so that the debt can be incurred without triggering MFN protection for the initial loan, such as incremental loans:

- With a final maturity date later than the maturity date of the initial term loans under the credit facility (see What's Market, WW International, Inc. credit agreement summary (final maturity date more than two years after the initial term loan maturity date)).
- Incurred in connection with a permitted acquisition or investment (see What's Market, Franchise Group, Inc. first lien credit agreement summary) or incurred up to a ratio-based amount (see What's Market, Petco Health and Wellness Company, Inc. first lien credit agreement summary).
- Consisting of a bridge financing provided the bridge financing converts into long-term debt (see What's Market, Resideo Funding Inc. amended and restated credit agreement summary).

Call Protection

Call protection, which requires a borrower to pay a prepayment premium or penalty if it prepays all (or a portion) of the loans, continues to be a common negotiated feature. In soft call provisions, lenders typically define repricing and refinancing transactions as those for which the primary purpose is lowering interest, with exceptions for certain transactions, including change of control, initial public offerings, and other transformative transactions. The change of control exception allows a sponsor to sell the borrower and repay the loans to recoup its investment without having to pay a prepayment premium. Transformative transactions are typically large-scale acquisitions, dispositions, and investments (for an example of a credit agreement with a call protection exception for transformative transactions, see What's Market, Paya Holdings III, LLC credit agreement summary). More recently, borrowers and their sponsors have requested a carve-out from call protection in connection with any material acquisition or disposition, as well as dividend recapitalizations (for an example of a credit agreement with a call protection exception for dividend recapitalizations, see What's Market, Signify Health, LLC credit agreement summary).

Regulatory Developments

The change in the political landscape with the Biden administration may have significant ramifications for the leveraged lending market. While the Trump administration loosened many of the financial regulatory rules that were put in place in the aftermath of the global 2008-2009 financial crisis, President Biden may take a more stringent approach to financial regulation. The Biden administration's priorities also differ from that of its predecessor and its policies and their implementation may impact business activity and the direction of the leveraged lending market as the agenda takes shape.

In 2017, the Government Accountability Office effectively eliminated the Leveraged Lending Guidance (LLG) for technical legislative reasons under the Congressional Review Act. However, with the Democrats now in control, there may be renewed interest in mandating certain minimum underwriting standards. Secretary of the Treasury Janet Yellen, as well as Chairwoman of the House Committee of Financial Services Maxine Waters both previously backed the LLG.

Secretary Yellen has also voiced support for pulling non-bank financial institutions under a stricter regulatory umbrella. Alternative lenders hold an advantage in the loan market, as they do not face the same regulatory constraints as banks. Secretary Yellen recently stated that "We need to change the structure of the Financial Stability Oversight Council (FSOC) and build up its powers to be able to deal more effectively with all the problems that exist in the shadow banking sector. I think the structure is inherently flawed. I think the agencies need a definite financial stability mandate."

Market watchers are also keeping an eye on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank). In 2018, Congress passed the Economic Growth, Regulatory Relief and Consumer Protection Act, which rolled-back several oversight measures placed on banks under Dodd-Frank. Secretary Yellen has praised Dodd-Frank, stating that increased regulations bolster the financial system, thereby setting the stage for a shift towards greater regulation in the future.

A key item on the Biden administration's agenda centers on climate change. According to market watchers, green banking and some regulation of the leveraged loan market may help push environmental initiatives forward. Pricing incentives and other favorable terms for borrowers incorporating environmental, social, and governance (ESG) measures into their loan documents are potential avenues to drive this change (see Sustainability Financing). The Biden administration's goal of net-zero emission targets may also play an indirect role on lenders' decisions concerning ESG metrics, according to market watchers. President Biden also earmarked $27 billion for a "Clean Energy & Sustainability Accelerator", also known as a green bank, in his American Jobs Plan, which supports and finances clean energy projects.

Interest Rates

The economic impact of the pandemic led the US Federal Reserve (Fed) to issue a series of **interest rate** cuts in 2020 in an effort to bolster the economy and steady the markets. In early March 2020, the Fed moved benchmark rates down by 50bps to a target range of 1.00% to 1.25% and then two weeks later slashed rates another full percentage point to bring them to near zero, where they have stayed since.

As was widely expected, the Fed decided to hold benchmark rates near zero at their June 2021 meeting. Despite an improving economic outlook, Fed Chairman Jerome Powell has indicated the need to adopt a cautious approach to tightening monetary policy to prevent a reversal in the country's economic fortunes. However, the Fed has indicated that interest rate rises may be expected in 2023.

In its deliberations regarding interest rates, the Fed must also keep a close watch on inflation, which Chairman Powell stated "… could turn out to be higher and more persistent than we expect." According to the Fed, inflation may reach 3.4% in 2021, a higher projection than the 2.4% predicted earlier this year.

Loan Defaults

Total leveraged loan default volume stood at $4.6 billion as of June 22, 2021, according to Fitch Ratings, significantly lower than the $37.1 billion recorded at the same time last year. Government aid, coupled with the vaccine rollout and re-opening of the economy, pushed levels down from the highs seen at the height of the pandemic. According to data from S&P Ratings, 20 rated US businesses defaulted as of April 22, 2021, considerably less than the 40 defaults reached in the same period last year. Fitch Ratings forecasts that the technology, healthcare and pharmaceuticals, and service and miscellaneous sectors (the three largest sectors of the institutional loan market) are likely to end the year with defaults rates at 1% or less. According to Fitch, the energy default rate is likely to reach 5% by year-end. The default rate for other sectors, especially areas hit hard during the pandemic, may be higher. According to Fitch Ratings, as of June 21, the projected default rate for the leisure and entertainment sector stood at 14%, while the retail sector was forecast to close at 7%. Market watchers are optimistic these industries will rebound as long as demand for travel and leisure activities continues to grow.

In June, Fitch Ratings decreased its overall 2021 default forecast to 1.5%, down from the 2.4% projected in May and 3.3% predicted in April. The current forecast is the lowest since 2011 (0.6%) and dramatically less than the 5% to 6% projected at the same time last year. According to Fitch, favorable conditions in the market may push this number even lower.

LIBOR Transition

On March 5, 2021, the ICE Benchmark Administration (IBA) announced publication of a feedback statement on its December 2020 consultation on IBA's intention to cease publication of all tenors of **LIBOR** settings. On the same date, in a related statement, the FCA announced that panel bank submissions for all LIBOR settings will cease (after which representative LIBOR rates will no longer be available) on the following dates:

- Immediately after December 31, 2021, in the case of all euro, sterling, Swiss franc, and Japanese yen settings, and the one-week and two-month US dollar settings.
- Immediately after June 30, 2023, in the case of the remaining US dollar settings.

Hardwired Fallbacks

US federal agencies have encouraged lenders to cease entering into new contracts that use LIBOR as a reference rate as soon as practicable, but by no later than December 31, 2021. New contracts entered into before December 31, 2021 should either use a reference rate other than LIBOR or have robust fallback language that includes a clearly defined alternative reference rate that would apply after LIBOR's discontinuation. Market participants should now be actively engaged in transitioning away from LIBOR to a successor rate.

Under the hardwired approach, fallback language is included in the credit agreement that provides that the loan automatically converts to the specified successor rate after a trigger event occurs. This differs from the amendment approach, under which, following a trigger event, the borrower and the administrative agent facilitate a streamlined amendment to replace LIBOR by selecting a successor rate and a spread adjustment. The Alternative Reference Rates Committee (ARRC) has published recommended fallback language for various cash products including syndicated and bilateral loans. In an increasing number of loan deals the parties are incorporating hardwired fallback language into their loan documents in preparation for a successful transition to a replacement rate. A month-to-month breakdown of the percentage of deals that followed the amendment approach or incorporated hardwired fallbacks (based on an analysis of 229 publicly-filed deals) is as follows:

	Amendment	Hardwired
January 2021	24%	76%
February 2021	15%	85%
March 2021	13%	87%
April 2021	10%	90%
May 2021	10%	87%
June 2021	4%	94%

SOFR and Credit Sensitive Rates

The ARRC has previously identified SOFR as its preferred LIBOR-alternative reference rate and there are currently several SOFR rates under consideration to replace LIBOR (including term SOFR and daily simple SOFR). Market chatter has indicated SOFR-based loans may actually be on the horizon in the near future. According to a report from Refinitiv, Ford Motor Co. recently hinted it may tie its loan to SOFR when it refinances its existing credit facility in the fall. It may not be the only one. According to the LSTA, the second half of 2021 may show an uptick in non-LIBOR loans because of the ARRC's recommendation that market participants cease issuing LIBOR-based loans by the end of June 2021.

Interest is also growing in credit-sensitive rates (CSRs) as alternatives to SOFR as possible replacements for LIBOR. Examples include the American Interbank Offered Rate (known as Ameribor) and Bloomberg Short-Term Bank Yield Index rate (BSBY). In response to member requests, the LSTA published sample language on April 8, 2021 for a rider that can be incorporated into hardwired fallback language so that loans may transition to a CSR.

Chairman Powell voiced his support last year for Ameribor as another alternative rate to LIBOR for certain banks, citing its appeal to smaller and mid-size regional and community banks that fund themselves through the American Financial Exchange. Some banks have already indicated their preference for Ameribor. According to a report from the American Banker, Zions Bancorp, an $81.5 billion-asset bank, announced its intent to use Ameribor in most loan contracts starting this summer. Larger banks are also testing non-SOFR benchmarks. For an example of a credit agreement referencing BSBY, see What's Market, Duluth Holdings Inc. credit agreement summary.

Legislation

On March 24, 2021, the New York legislature passed a bill that provides a framework for the upcoming transition away from LIBOR for all contracts, securities, and instruments governed under New York law that use LIBOR as a benchmark and that do not otherwise include fallback provisions. On April 6, 2021, then Governor Cuomo signed this bill into law. The law is expected to have limited impact on the syndicated loan market.

In February 2021, Chairman Powell also hinted that the Fed is open to federal LIBOR legislation to ensure a smooth transition for legacy contracts to a replacement rate, stating that "…federal legislation creating a path for a backup would be the best solution, we think." Chairman Powell's testimony represents a shift from a statement he made last year, when he told lawmakers "in terms of the need for federal legislation, we have not reached a point where we think it's going to be necessary."

Sustainable Financing

Sustainability-linked loans (SLLs) continued to gain traction in 2021 as an increasing number of US companies looked for ways to incorporate more environmentally-friendly, sustainability, and good governance metrics and targets into their loan documents. For example, in March 2021 BlackRock Inc. amended its credit facility to, among other things, tie the margin on its loans to increasing its diversity efforts and meeting certain sustainability goals. In a further example, in April 2021, General Mills added an ESG metric to its credit agreement to become the first borrower in the consumer packaged goods industry to execute an SLL-linked facility (for additional examples of sustainable financing credit agreements, see summaries for HP Inc. and Lam Research Corporation). As the SLL market matures, more different types of borrowers may enter into these facilities and more changes in the terms of these documents may emerge.

According to data obtained from Refinitiv on June 25, 2021, the global green loan and SLL volume was about $290 billion, up from about $85 billion for the same period in 2020. SLLs represented more than 90% of this volume, up from about 60% in 2020. Issuance of US loans with terms tied to sustainability targets topped $52 billion through May 21, a staggering 292% increase over the entire 12-months of 2020, according to data from Bloomberg. Market participants anticipate continued interest in SLLs in the US market, especially considering the Biden administration's focus on climate change and environmental matters.

SLLs are just one of the sustainable financing products in the market along with green loans, green bonds, social loans, and others but they are increasingly popular because of their availability to all types of companies and the diversity in the terms they offer. Unlike green financing products, SLLs do not have a use of proceeds provision which requires the loans to be used for a green or environmentally-friendly project or purpose. Rather, they are performance-based loans with terms (typically, interest rate margins) that adjust up or down depending on the borrower's ability to meet pre-determined sustainability performance targets (SPTs) as measured by pre-defined key performance indicators (KPIs). The KPIs that must be met are varied and range from environmental targets to increasing diversity in the borrower's board of directors.

The LSTA, together with the Loan Market Association (LMA) and the Asia Pacific Loan Market Association (APLMA) have published several documents relating to principles and guidance for sustainable financing. Originally published in 2019, the Sustainability-Linked Loan Principles (SLLP) and the Guidance on Sustainability-Linked Loan Principles (GSLLP) were most recently updated in May 2021. The 2021 updates were published in response to the dramatic increase in the volume of SLLs and are intended to promote transparency and integrity in the SLL market and tighten the language regarding the choice of KPIs and scope of SPTs. Key changes to the SLLP and the related GSLLP include:

- Providing a clear definition of the KPIs.
- Selecting creditable KPIs that are material to the borrower's "core sustainability and business strategy" and address ESG challenges in the borrower's industry.
- Establishing ambitious and appropriate SPTs with which the borrower must comply under an SLL transaction.
- Engaging an independent third party to verify the borrower's performance against each SPT for each KPI.

The updated SLLP and related GSLLP became effective for SLL transactions entered into on and after June 3, 2021.

SPACS

Competition in the M&A space remains fierce as an increasing number of venture-backed companies turn to SPACs as a vehicle to complete acquisitions. A SPAC is an entity formed for the purpose of funding and completing a business combination. It offers an alternative to going public for a private company, while enabling it to raise capital in the public equity markets. SPACs are formed by sponsors with the experience and expertise of raising money in an IPO which is then used by the SPAC to acquire a private business. While the SPAC is a public company and the target is not, the SPAC must report the target's financial results combined with its own in consolidated reporting.

SPAC IPO activity in 2021 is on course to eclipse even the record numbers observed in 2020. According to SPACresearch.com, US SPAC IPO issuance totaled 378 as of July 21, 2021 compared to 248 SPAC IPOs in the whole of 2020.

SPACS have successfully negotiated leveraged loan packages on market terms (even agreeing to covenant-lite terms although maximum leverage multiples are likely to be lower than in private equity deals). Both traditional banks and direct lenders have provided funding. According to market participants, a key trend that has emerged in leveraged loan negotiations involving private borrowers is to allow the acquisition of the borrower by a SPAC. In this case, the SPAC acquisition is treated as if it were a permitted IPO and does not constitute change of control under the loan agreement, which is commonly an event of default. An important practical advantage for a target company acquired by a SPAC is that it can refinance its debt using the SPAC's IPO proceeds, enabling it to delever and reduce its debt servicing costs and create a stronger balance sheet.

Some investors are concerned that SPACs may be part of a market bubble that may burst at any time. The House Committee on Financial Services also recently proposed legislation to regulate SPACs more stringently. The draft bill, which amends the Securities Act of 1933 and the Securities Exchange Act of 1934, looks to exclude all SPACs from safe harbor protection for forward looking statements.

Liability Management Transactions

During the past few years, multiple high-profile litigation cases, such as J. Crew, PetSmart, and more recently Serta Simmons Bedding, have pushed lenders to adopt measures that better protect their collateral from being used by borrowers to secure additional funding that is permitted under the breadth of their loan agreement permissions.

Drop-Down Financing

Following J. Crew, lenders turned their attention to the designation of "unrestricted subsidiaries" and the transfer to those unrestricted subsidiaries of material intellectual property assets outside of the existing collateral pool. In a drop-down financing, a company incurs new debt financing through a newly formed or designated unrestricted subsidiary or another non-guarantor subsidiary secured by assets technically outside of the existing collateral package. The borrower has taken the assets securing the new debt and either sold or transferred them to a subsidiary outside the credit group. Known as a "trap door" maneuver, the assets are now outside the reach of the existing secured creditors and can be used to obtain new financing.

As a way to prevent this movement of valuable assets outside the credit group, lenders continue to tighten their credit agreements and negotiate so-called J. Crew blockers. These blocker provisions may take many forms, such as requiring lender consent to designate an unrestricted subsidiary or restrictions on investments in or transfers of intellectual property or material assets to unrestricted subsidiaries.

For an example of a credit agreement with a J. Crew blocker, see What's Market, Petco Health and Wellness Company, Inc. first lien credit agreement summary.

Uptiering Transactions

A more recent trend involves the use of "uptiering." In a typical uptiering scenario, a subset of existing lenders delivers new "super-priority" loans to a borrower, which then receives enhanced lien priority over the existing collateral to secure their claims. Uptiering transactions commonly involve:

- Super-priority loans provided by a subset of existing lenders.
- "Rolling up" of existing debt of participating lenders into pari passu super-priority or second priority loans.
- Subordinating the existing loans of non-participating lenders to the new loans.

Practitioners expect uptiering transactions to remain a popular feature of the leveraged loan market in 2021. Negotiated points between loan parties are likely to center on numerous issues, including voting, waterfall distribution, pro rata sharing, intercreditor limitations, exit consents, subordination, and open market purchases. Some market participants have also broached the idea that lenders make subordination of claims or liens a sacred right in the loan agreement, which then requires a 100% vote of affected lenders.

For an example of an uptiering transaction, see What's Market, Owens & Minor Distribution, Inc. credit agreement.

Direct Lending

In 2020, large US lenders' loan books fell for the first time in more than ten years, according to a Wall Street Journal report. According to the report, "Bank of America's loans and leases dropped by 5.7%, Citigroup's loans dropped by 3.4%, and Wells Fargo's shrank by 7.8%. Among the biggest four banks, only JPMorgan Chase had more loans at the end of the year than the start."

There is increasing competition for high quality credit and market watchers expect direct lending activity to continue to grow in the middle market. From a borrower's perspective, an appealing advantage of direct lending is that alternative lenders tailor their financing proposals more closely to the needs of an individual business and offer some of the benefits of traditional relationship lending. Unlike in the syndicated market, there is no syndication risk in direct lending leading to certainty of funds, as well as a speedier closing process, which is a significant advantage for a borrower in a competitive acquisition environment. Direct lenders may also be more willing to provide increased flexibility around leverage, amortization, EBITDA adjustments, and covenant limitations.

Market participants are also keeping watch on digital technologies, which they believe will be necessary to move the direct lending market forward post-pandemic. According to observers, the remote-work landscape and increased reliance on virtual mediums will lead many market participants to conduct business online, which will require investment in digital workflows and technologies.

Overall, practitioners predict the number of non-bank lenders entering the space, coupled with increased capital and economic growth, will continue to drive the market throughout the remainder of 2021.

Looking Forward

As the US economy continues to rebound, borrowers and lenders in new deals are expected to center much of their negotiations around the level of operational flexibility for borrowers in loan agreement covenant packages. Inflation is expected to remain a primary concern for loan investors throughout 2021, which may lead to increased investor demand for leveraged loans. Further COVID-19 waves caused by new variants may also have an impact on the loan market.

Lenders are also likely to watch the Biden administration closely for any tightening of regulations, which may impact certain sectors of the economy and have a knock-on effect on deal flow. Given the administration's emphasis on climate change, the sustainable-financing market is also likely to remain a popular segment within the leveraged loan market.

Market observers also expect borrowers and lenders to continue to prepare their loan documents for the discontinuation of LIBOR.

The market statistics cited in this article (unless otherwise stated) were provided by Refinitiv LPC, an LSEG business.

For a complete copy of this article published on the Practical Law website on July 22, 2021 which also includes links to recent examples of loan agreements and Expert Views from leading industry experts, see Practice Note, What's Market: 2021 Mid-Year Trends in Large Cap and Middle Market Loan Terms, Practical Law, at http://us.practicallaw.tr.com/w-030-9114.

Lenders and Small Businesses: A New Dynamic under Subchapter V of Chapter 11

by Ira L. Herman and Evan J. Zucker, Blank Rome LLP

Subchapter V of Chapter 11 of the Bankruptcy Code[1] was enacted for the stated purpose of reducing barriers to the Chapter 11 process for small businesses by streamlining the reorganization process and limiting costs.[2] When enacted in 2019,[3] the definition of "small business debtor," set forth in section 101(51D) of the Bankruptcy Code, included a debt cap of $2.5 million. In 2020, in a partial response to the COVID-19 pandemic, Congress increased the debt cap to $7.5 million in secured and unsecured non-contingent and liquidated debt.[4]

Between February 19, 2020 and September 30, 2020, more than 2,200 Subchapter V cases were filed in the United States.[5] Approximately 20% of such cases have been confirmed. This confirmation rate is no less than six times higher than the percentage for small business Chapter 11 cases that did not proceed under Subchapter V during the same period.[6] On its face, this statistic suggests that Subchapter V is working to help small to medium size businesses reorganize under Chapter 11. However, the enhanced success rate does not at all address the impact such cases have had on creditors rights and recoveries – particularly on holders of funded debt claims.

In a Subchapter V case, a number of the traditional Chapter 11 rights and remedies of secured and unsecured creditors are limited or modified. This article first identifies several of these limitations and modifications and then proposes strategies lenders may employ to enhance recoveries, when a customer becomes a debtor in a Subchapter V case.

A. SUBCHAPTER V LIMITATIONS ON LENDER RIGHTS

1. The Elimination of the Absolute Priority Rule and Certain Voting Rights

Subchapter V eliminates the "absolute priority rule," meaning that a Subchapter V debtor may retain its property, even if it does not pay its creditors in full. Moreover, Subchapter V, eliminates the traditional Chapter 11 confirmation requirement of acceptance by an impaired class of creditors. However, the concept of acceptance by an impaired class does not disappear entirely in a Subchapter V case, rather acceptance of the Subchapter V plan by the voting classes of creditors[7] may be beneficial to a debtor – providing creditors with some leverage as they negotiate with a Debtor. How so? Confirming a consensual plan under Subchapter V has at least two significant benefits for the debtor: (a) an earlier discharge and (b) the right to keep post-petition property outside of the bankruptcy estate. On the other hand, in exchange for the elimination of the traditional confirmation requirement of acceptance by an impaired class of creditors (*i.e.*, a non-consensual plan), all of a debtor's projected disposable income for a three to five years period must be paid to creditors, and the debtor does not receive a discharge until the completion of its plan payments.

2. <u>Payment of Administrative Expense Claims Can Affect Plan Length</u>

In order to confirm a reorganization plan in a traditional Chapter 11 case, a debtor (or plan proponent) is required to pay in full all of its administrative expenses – that is, all of the post-petition expenses that "are actual and necessary costs and expenses of preserving the estate." 11 U.S.C. § 503. In a Subchapter V case, if the plan is nonconsensual, a debtor is not required to pay administrative claims at confirmation (unless otherwise agreed) – it can stretch them out over the life of the plan (*i.e.*, three to five years). This treatment of administrative expenses in Subchapter V cases, significantly changes the debtor/creditor dynamic from the dynamic that exists in traditional Chapter 11 cases. For example, where a debtor has incurred substantial administrative expenses, it may find itself in a totally counterintuitive position - preferring a contested plan confirmation to a consensual plan confirmation, since it can stretch out the payment of administrative expenses. On the other hand, distressed investors (claims traders) with holdings consisting of unsecured claims or equity interests still will want to limit administrative claims, since such expenses will be paid in full ahead of their claims and interests.

3. A Subjective Projected Disposable Income Test and Limitations on Post-<u>Confirmation Modification</u>

To confirm a non-consensual Subchapter V plan, a debtor must demonstrate that it is providing "all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix." 11 U.S.C. § 1191(c). After confirmation of a Subchapter V plan, only the debtor may modify the plan if the projections turn out to be incorrect. 11 U.S.C. § 1193. Thus, in a Subchapter V case, if the debtor's business improves significantly after confirmation during the term of the plan or the debtor's projections prove to have been overly pessimistic, there is no provision in Subchapter V permitting a lender to request modification of the plan to increase payments to match the post confirmation income being generated by the debtor. However, if the post-confirmation income stream is less than projected at confirmation, the debtor can request a modification of the plan under Subchapter V, even though the plan has been substantially consummated. 11 U.S.C. § 1193(c). This is different than in a traditional Chapter 11. In a typical corporate Chapter 11 case, a confirmed plan may be modified by the plan proponent or reorganized debtor at any time after confirmation, but before substantial consummation of the plan. 11 U.S.C. § 1127(b). And, with respect to traditional individual Chapter 11 debtors who seek to modify a confirmed plan, there is a more level playing field post-confirmation, as with regard to individual Chapter 11 debtors "the plan may be modified at any time after confirmation of the plan but before the completion of payments under the plan, whether or not the plan has been substantially consummated, upon request of the debtor, the trustee, the United States trustee, or the holder of an allowed unsecured claim." 11 U.S.C. § 1127(e).

4. <u>Modification of Mortgages on the Debtor's Principal Residence</u>

In the traditional Chapter 11 case, the plan may not modify the rights of creditors holding a claim secured solely by an interest in a debtor's principal residence. This anti-modification rule generally prevents debtors from "stripping down" a loan or, in other words, voiding a creditor's lien to the extent the debt secured by a principle residence is less than the value of the residence. This is lender protection is eliminated in Subchapter V cases.

When a debtor seeks to confirm a traditional Chapter 11 plan over the objection of a secured creditor, the plan must "not discriminate unfairly" and be "fair and equitable" with respect to each class of creditors that voted against the plan. 11 U.S.C. § 112(b). Generally, a traditional Chapter 11 plan is "fair and equitable" with respect to the treatment of a secured claim if the plan either (a) provides for the retention by the holder of the claim of the liens securing the claim and the payment to the holder of deferred cash payments totaling at least the allowable amount of the claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in the property securing the liens, (b) provides for the sale of the property securing the liens, free and clear of the liens, with the liens to attach to the proceeds of such sale, and the treatment of such liens, or (c) the plan provides for the realization by the holder of the secured claim of the "indubitable equivalent" of such claim. 11 U.S.C. §§ 1129(b) & 1191(c)(1). Subchapter V does not change the "fair and equitable' standard, but it does change the general rule under section 1123(b)(5), by authorizing a debtor to modify the rights of certain holders of claims secured only by a mortgage lien in a debtor's principal residence, when the proceeds of the relevant mortgage were used primarily in connection with such debtor's business. 11 U.S.C. § 1190(3). Specially, section 1190(3) provides that a plan, "notwithstanding section 1123(b)(5) of this title, may modify the rights of the holder of a claim secured only by a security interest in real property that is the principal residence of the debtor if the new value received in connection with the granting of the security interest was (a) not used primarily to acquire the real property; and (b) used primarily in connection with the small business of the debtor." 11 U.S.C. § 1190(3). Thus, if a mortgage is not a purchase money mortgage and was used to finance a business enterprise, then a debtor may be able to modify that mortgage by confirming a Subchapter V plan.

5. **Guarantees**

Subchapter V does not change the law concerning obligations of non-debtor related parties, including guarantors. It neither changes the scope of the automatic stay nor expands the scope of a discharge. Thus, a lender's rights against a guarantor under Subchapter V are just like the lender's rights against a guarantor in a traditional Chapter 11 case. Absent an injunction extending the automatic stay to a non-debtor guarantor, the automatic stay in a Subchapter V case does not protect a guarantor, and, similarly, confirmation of a Subchapter V plan does not serve a to release a guarantor, without an appropriate showing under the applicable law regarding a non-debtor release included in a plan of reorganization.

Given certain perceived advantages of Subchapter V for a debtor, an individual guarantor may want to file a Subchapter V case to deal with personal liabilities arising out of guarantees or other obligations related to a failed business. A split of authority exists on whether an individual, who guarantees a business debt, qualifies for Subchapter V relief, as the issue has been argued, the individual at issue has not "engaged in commercial or business activities" where the business giving rise to the debts is no longer operating. In *In re Wright*, 2020 WL 2193240 (Bankr. D. S.C. 2020), the court held that nothing in the definition limits the scope of Subchapter V eligibility to a debtor currently engaged in business and ruled that an individual who guaranteed debts of two limited liability companies that were no longer operating could proceed in a Subchapter V case. *Accord, In re Bonert,* 619 B.R. 248, 255 (Bankr. C.D. Cal. 2020); *see In re Blanchard*, 2020 WL 4032411 (Bankr. E.D. La., 2020). Other courts have reached a contrary outcome and concluded that a debtor must currently be engaged in business to be eligible for Subchapter V relief. *See In re Thurmon,* 625 B.R. 417 (Bankr. W.D. Mo., Dec. 8, 2020). In *Thurmon*, the court reasoned, "[t]he plain meaning of 'engaged in' means to be actively and currently involved. In § 1182(a)(1)(A) of the Bankruptcy Code, 'engaged in' is written not in the past or future but in the present tense."

B. **CREDITOR STRATEGIES**

1. **Objecting to a Debtor's Eligibility**

Given the benefits provided to a debtor (at the expense of creditors) under Subchapter V, a lender should be aware of potential strategies a debtor may employ to satisfy the eligibility requirements of Subchapter V and how to challenge a debtor that employs such strategies. For example, a debtor might attempt to assign debts to non-affiliate insiders, might characterize debts as contingent or nonliquidated, without an appropriate evidentiary foundation, or negotiate with friendly creditors to reduce or pay their claims, pre-bankruptcy, to qualify for the "small business" debt limit. A lender could be well served to strategically object to a debtor's Subchapter V election, if it suspects gamesmanship concerning eligibility and is concerned about the cram-down provisions available to Subchapter V debtors. Interim Bankruptcy Rule 1020(b) provides that a creditor has until 30 days after the conclusion of the meeting of creditors held under 11 U.S.C. § 341(a) to object to the Subchapter V election. Filing and sustaining such an objection, however, can be a costly endeavor and often will require discovery due the fact intensive nature of the inquiry. Finally, because Subchapter V requires a plan to be filed within 90 days of the commencement of the case, the prosecution of an objection regarding eligibility can at least play an important role in plan negotiation because of the risk to a debtor that it will be disqualified for Subchapter V.

2. **Leveraging a Lender's Section 1111(b) Secured Creditor Elections**

Under section 506(a) of the Bankruptcy Code, a secured claim held by a lender is limited to the value of its collateral, while the lender is left with a general unsecured claim for all amounts outstanding that are in excess of that value. Section 1111(b) of the Bankruptcy Code provides that an under-secured creditor can avoid the effect of Section 506(a) and elect to have the full amount of the outstanding indebtedness as being fully secured at the time in the future when the collateral is to be liquidation, despite the fact that the actual value assigned to the collateral at confirmation is less than the amount outstanding at confirmation. The election can be quite important to a lender that believes the value of its collateral is temporarily depressed or undervalued (*e.g.*, due to the COVID-19 pandemic or other causes). Absent the exercise of the 1111(b) election, the operation of Section 506(a) will result in the under-secured lender receiving (a) the net present value of its collateral on the secured portion of its claim, and (b) a *pro rata* share of distributions under the plan on account of its unsecured deficiency claim. By exercising the right of election, the lender's lien remains, the amount secured by the lien remains intact and the lender will receive an income stream equal to the present value of the collateral. The payments made will be applied to the amount of the claim secured by the lien. Thus, if the lender's collateral is worth $1 million and the amount secured by the lien is $2 million, for the lien to be satisfied, the lender will have to receive $2 million of payments over time, while the present value of such payments must be (at least) $1 million. In this example, if the lender has been paid $1 million dollars over time after confirmation of a plan, and the debtor wants to sell the property, it will have to pay the lender the amount remaining due on account of the lien or $1 million.

Traditionally, in deciding when to make an election, an under secured creditor must consider the practical effects of not making such election – *i.e.*, that its claim would be bifurcated, with it retains the ability debtor to vote as both a secured creditor and unsecured creditor on a debtor's Chapter 11 plan. And, because a debtor is required to have at least one accepting impaired consenting class, a lender may hold a blocking position. The analysis, however, changes in a Subchapter V case because a debtor is not required to have an impaired accepting class as a condition of confirmation.

There is, however, an exception to a lender's 1111(b) election right. Under the so-called "inconsequential value exception" to the 1111(b) election right, "[a] class of claims may not elect the application of paragraph (2) of this subsection if—(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value. . . ." 11 U.S.C. § 1111(b)(1)(B)(i). The term "inconsequential" is not defined in the Bankruptcy Code. Courts have used different approaches in analyzing the "inconsequential value exception." Some courts compare the value of the asserted secured interest with the overall value of the collateralized asset to determine whether the lien is of "inconsequential" value. Other courts compare the value of the security interest to the total dollar amount of the underlying secured claim. And, in the context of a Subchapter V case, there is a dispute as to whether a court should consider the fact that the case is one under Subchapter V in determining whether the lien is of inconsequential value. *Compare In re Body Transit, Inc.*, 2020 WL 4574907 (E.D. Penn. August 7, 2020) *with In re VP Williams Trans, LLC*, Case No. 20-10521 (MEW), 5-9 (Bankr. S.D.N.Y. Sep. 29, 2020).

In *Body Transit*, the Court found that the purposes underlying Subchapter V influenced its determination of whether the value at issue was "inconsequential." And, since the purpose of Subchapter V was to permit a small business to satisfy unsecured portions of claims by paying their projected disposable income for three to five years, and that this favored a lenient interpretation of the definition of "inconsequential" and section 1111(b). The Court, in *VP Williams Trans*, however, rejected such considering stating:

> But I do not see how that should have any bearing on the interpretation of section 1111(b). Congress also desired to foster other forms of chapter 11 reorganizations, but section 1111(b) applies in all chapter 11 cases, including subchapter V. If section 1111(b) was supposed to give way in a subchapter V case, or to have a different application in such a case, that was for Congress to say, and Congress did not do so. Furthermore, while it is true that Congress desired to foster reorganizations under subchapter V when a small business debtor agrees to devote its projected disposable income to payments under the plan, that is only one of the tests that must be applied. See 11 U.S.C. § 1191(c).

3. Investigate Debtor's Financial Projection to Minimize Cramdown Risk and/or Negotiate a Consensual Plan

Determining the amount of a debtor's disposable income will be critical to either negotiating (and accepting) a consensual plan or forming the basis for opposing confirmation of a non-consensual plan. "Disposable income" for the purposed of Subchapter V means "the income that is received by the debtor and that is not reasonably necessary to be expended . . . (2) for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor." 11 U.S.C. § 1191(2). As set forth above, a debtor will have the incentive to "lowball" its projected revenues and to maximize its projected expenses. That is particularly true in the current macro-economic environment, as the economic recovery from the COVID-19 pandemic continues at an unpredictable pace. Given the informational disparity concerning what a debtor knows about its finances and what a creditor may know, a creditor may choose to employ the contested proceeding discovery rules or examinations, under Fed. R. Bankr. P. 2004, to investigate the validity of the Debtor's projected disposable income. A word of caution: this will have to be done expeditiously, due to the relatively short amount of time available for a lender to act in the context of a Subchapter V case to contest plan confirmation.

C. CONCLUSION

While Subchapter V provides many benefits to a small business debtor, lenders and other creditors are not left without options. A lender will be well served by acting decisively and taking certain steps available to it under the new statutory scheme to protect its interests and maximize its recovery. However, because of the streamlined reorganization process now available to small businesses under Subchapter V, the old admonition, "if you snooze you lose" is truer than ever.

By Carl S. Bjerre and Stephen L. Sepinuck

The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the decisions.

In re K & L Trailer Leasing, Inc.
630 B.R. 81 (Bankr. E.D. Tenn. 2021)

This case concerns the method for perfecting a security interest in collateral subject to a certificate-of-title statute after the original debtor, who is in the business of selling goods of that kind, transfers the collateral to an entity in the business of leasing, but not selling, such property. The court concluded that a secured party that perfected by filing a financing statement remained perfected after the transfer, but in doing so the court overlooked an interesting limitation on the continued effectiveness of financing statements.

Greenville Federal Bank (the Bank) had a security interest in big-rig trailers held as inventory for sale by the original debtor, K & L Trailer Sales & Leasing, Inc. ("Sales"). An affiliate of Sales, K & L Trailer Leasing, Inc. ("Leasing"), sometimes found third parties interested in leasing a trailer, at which time Sales sold the trailer in question to Leasing. But shortly before a bankruptcy filing by both Sales and Leasing, Sales began transferring trailers to Leasing at a greatly increased volume, even without the prospect of leases with third parties. The Bank sought a declaration from the bankruptcy court that it had a first-priority security interest in the trailers sold to Leasing. The bankruptcy trustee, in opposition, moved for judgment on the pleadings, arguing that the Bank's security interest in the trailers sold was no longer perfected. The court held in favor of the Bank, and denied the trustee's motion.

The court first ruled that the Bank's security interest in the trailers remained attached after the sale. This was correct. After all, neither of the exceptions contained in U.C.C. § 9-315(a)(1) to continued attachment following a sale was satisfied. First, the Bank did not authorize the sale free of the security interest. Second, Sales did not have the power to transfer the Bank's rights to Leasing under the entrustment rule of § 2-403(2) because, based on the pleadings, Leasing did not qualify as a buyer in ordinary course of business. The court also correctly recognized that, before the sale of the trailers, the Bank's security interest was properly perfected because the Bank had duly filed a financing statement against Sales. Although the trailers were subject to Tennessee's certificate-of-title statute ("COT Statute"), which under § 9-311(a)(2) would normally mean that a secured creditor must comply with the COT Statute (*i.e.*, by causing the security interest to be reflected on the state-issued certificate of title) to perfect its security interest, because Sales was in the business of selling big rig trailers, § 9-311(a)(2) did not apply. Instead, perfection was through compliance with Article 9's filing system. *See* § 9-311(d) (while collateral subject to a COT Statute is "inventory held for sale or lease by a person" and that person is in "the business of selling goods of that kind," section's referral to other statute does not apply); *id.* cmt. 4 (when subsection (d) applies, compliance with COT statute is "both unnecessary and ineffective"); § 9-310(a) (perfection is by filing unless otherwise specified).

Perfection of the Bank's security interest after the sale to Leasing, though, is a more complex matter. The court focused on § 9-507(a), which provides that a filed financing statement "remains effective" with respect to the collateral transferred by the original debtor. 630 B.R. at 88-89. The court apparently understood that § 9-311(d) treats titled goods held for lease differently from titled goods held for sale. Specifically, compliance with the COT Statute – rather than filing a financing statement – is necessary to perfect a security in titled goods held for lease. That is because when the debtor holds the titled goods for sale, ownership is likely to change relatively quickly, making compliance with the COT Statute rather burdensome: the secured party's interest would need to be added to the certificate when the debtor acquires the goods and then removed therefrom soon after the debtor sells them. In contrast, when the debtor holds titled goods for lease, and no quick sale is expected, compliance with the COT Statute is much less of a burden. Nevertheless, the court concluded that the Bank's filed financing statement against Sales was sufficient to maintain perfection of its security interest in the trailers now owned by Leasing.

The court's mistake was in further thinking that § 9-507(a) provides the governing rule. In fact, it does not. Section 9-507(a) is a *filing* rule, not a *perfection* rule, a point reflected by Article 9's text, structure, and policy.

Textually, several other provisions of Article 9 expressly state that a security interest "remains perfected" in spite of a post-filing event. *See, e.g.*, §§ 9-311(b), 9-312(f), (g), 9-316(a), (d), (f), (g), (h)(2), (i)(2), 9-335(b). *See also* § 9-336(c) (dealing with commingled goods). Section 9-507(a), however, does not state that "perfection" continues. Indeed, it does not refer to perfection at all. It states only that "a filed financing statement remains effective" – meaning that it remains effective *as a filed financing statement*. In most situations, the continued efficacy of a financing statement means that the security interest in the collateral sold will indeed remain perfected. But the continued efficacy of a financing statement has no relevance to a security interest that can no longer be perfected by a filed financing statement, as was true in this case after Sales sold the trailers to Leasing.

Structurally, it is worth noting that § 9-507(a) appears in Part 5 of Article 9 (entitled "Filing") rather than Part 3 (entitled "Perfection and Priority"). The rule says nothing about whether a security interest is perfected if: (i) the security interest could never be perfected by filing; or (ii) as, as in this case, the security interest prior to the sale could be perfected by filing but after the sale could not be. This point is confirmed by comment 3 to section 9-507, which provides: "Subsection (a) addresses only the sufficiency of the information contained in the financing statement. A disposition of collateral may result in loss of perfection for other reasons."

From a policy standpoint, it is important to understand that Article 9's filing system is *debtor-based*. That makes filing easy but sometimes puts a greater burden on searchers. In particular, because § 9-507(a) frees the secured party from amending its filing when the collateral is sold to a buyer located in the same state, "any person seeking to determine whether a debtor owns collateral free of security interests must inquire as to the debtor's source of title and, if circumstances seem to require it, search in the name of a former owner." § 9-507 cmt. 3. COT Statutes, in contrast, operate differently. They create a *collateral-based* filing system. Such systems are designed precisely so that a party interested in acquiring an interest in the titled goods can rely on the certificate. Furthermore, Article 9's debtor-based system defers to the collateral-based system of COT Statutes except in the narrow circumstance when the goods are inventory held by a person engaged in selling such goods. *See* §§ 9-311(a)(2), (d), 9-337 (clean certificate of title issued by one state protects buyer or secured party from security interest previously perfected under the law of another state).

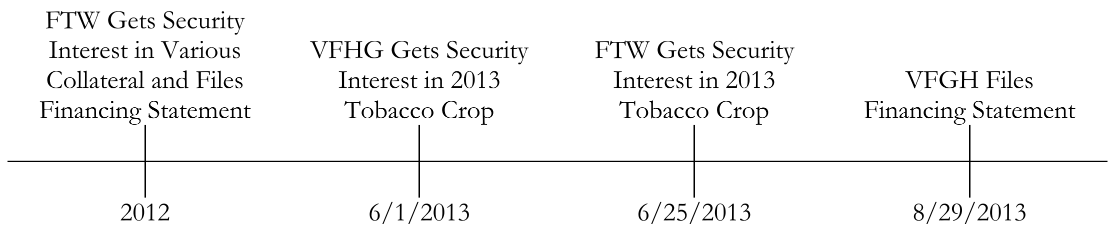
To be sure, the facts in this case present a challenging problem for a secured party such as the Bank. It loses perfection – instantaneously – upon the sale of the goods to anyone not in the business of selling the goods, and there is little it can do to protect itself. But immediate loss of perfection arising from unilateral debtor action can occur in other situations as well. Consider, for example, a debtor that registers a previously unregistered copyright, thereby requiring perfection by compliance with federal law rather than by compliance with Article 9. *See* § 9-109(c)(1). Furthermore, consider another situation that is directly comparable to the facts of this case. A debtor in the business of selling titled inventory starts using some of the goods as equipment. At that moment, U.C.C. § 9-311(d) ceases to apply and compliance with the COT Statute would be the only way to perfect. Hence, a security interest previously perfected by filing a financing statement immediately becomes unperfected. This result is expressly confirmed by the last paragraph of comment 4 to U.C.C. § 9-311. It is also why many lenders providing floor plan financing to used car dealers regularly check the mileage of each financed vehicle: to make sure that no financed vehicle has become equipment. Moreover, this is the result even though § 9-507(b) states that a filed financing statement "is not rendered ineffective" if the information provided in it becomes seriously misleading (*e.g.*, the financing statement identifies the collateral as "inventory" but, after the financing statement was filed, the collateral becomes "equipment"). In other words, both the official comments to § 9-311 and prevailing practices by secured parties indicate that § 9-311(a) (a perfection rule) controls over § 9-507(b) (a filing rule). There is no reason to think that the primacy of § 9-311 somehow falters merely because the post-perfection change in circumstances is a sale, to which § 9-507(a) applies, rather than a change in the collateral's classification, to which § 9-507(b) applies.

One final point is worth making. The court's approach – which allows a security interest in a vehicle perfected by filing to remain perfected following sale – leads to unfortunate results. Consider a situation in which a lender has a security interest in a used car dealer's inventory. The security interest is perfected by a filed financing statement. The dealer then sells a car to a buyer in satisfaction of an existing obligation. Because such a buyer does not qualify as a buyer in ordinary course of business, the buyer takes subject to the security interest. S*ee* § 1-201(b)(9). If, as the court's analysis suggests, § 9-507(a) controlled, the security interest would remain perfected despite it never being noted on the car's certificate of title. A person later interested in acquiring rights in the car – either by buying the car or merely acquiring a security interest in it – would have no ready means of determining that there was an existing perfected security interest in the car. Nevertheless, such a person would normally take subject to the still-perfected security interest (assuming that all parties are located in the same state). *See* discussion of § 9-337 above. As a result, a central purpose of the COT Statute would be undermined.

Versailles Farm, Home and Garden LLC, v. Haynes,
2021 WL 519722 **(Ky. Ct. App. 2021)**

This is a case about the priority of a security interest securing future advances. The court might have reached the correct result, but its analysis has errors of both commission and omission.

The debtor was a farmer to whom Farmers Tobacco Warehouse ("FTW") began making secured loans in 2012, at which time FTW filed a financing statement. In June 2013, the debtor borrowed $75,000 from Versailles Farm, Home and Garden, LLC ("VFHG"), which obtained a security interest in the debtor's 2013 tobacco crop. VFHG apparently did not conduct a search for filed financing statements. Later that same month, the debtor granted FTW a security interest in the same tobacco crop. On August 29, 2013, VFHG perfected its security interest by filing a financing statement. In November, it notified FTW of its security interest and requested to be included as a payee on any checks constituting proceeds of the crop.



The debtor later sold the tobacco crop and used the proceeds to pay FTW. VFGH then sued FTW for conversion.

VFHG did not dispute that FTW's security interest was perfected and that FTW was the first to file. What it did argue was that FTW's June 2013 security agreement covering the tobacco crop did not contain a future advances clause, and accordingly covered only what the debtor owed to FTW up until that date. In making this argument, VFHG cited to *ITT Industrial Credit Co. v. Union Bank and Trust Co.*, 615 S.W.2d 2 (Ky. App. 1981), which held that a secured party with a perfected security interest in collateral does not have priority over a subsequent lender's perfected security interest in that collateral if: (i) the original loan to the secured party lacks a future advances clause and is fully paid off; and (ii) the secured party then makes a new loan secured by the same collateral. The court rejected this argument, but not for the right reasons.

First, the *ITT Industrial* case was wrong when decided (under old Article 9) but is even more clearly incorrect under the current version of Article 9. Priority between two security interests in the same collateral is governed by the first-to-file-or-perfect rule of § 9-322(a)(1). The fact that the original loan was paid off is immaterial. In fact, even if the original loan had never been made, the first to file would have priority. As long as the later advance was in fact secured by the collateral, priority dates from when the financing statement was filed.

Unfortunately, the court in *Versailles Farm* latched onto some dicta in the *ITT Industrial* case, in which that court based its conclusion on the rationale that it was better to require the original creditor to provide for future advances in the first security agreement, which would provide "actual notice" of its intention to a subsequent creditor. 2021 WL 519722, at *3-4. The *Versailles Farm* court then distinguished *ITT Industrial* because VFGH had not bothered to do a search and review FTW's security agreement. For this reason, FTW had priority. The court suggested, however, that the result would be different if VFGH had reviewed FTW's security agreement and seen that it contained no future advances clause.

Almost everything the court wrote was irrelevant or wrong. Priority, as noted above, is determined by the first-to-file-or-perfect rule. FTW filed first. Regardless of when FTW's security agreement was authenticated, regardless of when the debtor's secured obligation to FTW was incurred, and regardless of VFGH's actions and knowledge, FTW's security interest had priority of VFGH's security interest.

What the court failed to discuss, however, was the extent of the secured obligation that the debtor owed to FTW. If FTW used the proceeds of the tobacco crop to pay a debt incurred after the debtor authenticated the 2013 security agreement, then the absence of a futures advance clause in that security agreement could be critical. FTW's security interest had first priority, but that security interest simply might not have secured the later indebtedness. For the later advance to be secured by the collateral in the absence of a future advances clause in the 2013 security agreement, there would need to be either an amendment to that agreement or a later agreement that grants a security interest in the tobacco crop to secure that advance.

So, the court made two mistakes. First, it incorrectly suggested that priority depended on whether: (i) the 2013 security agreement contained a future advances clause; and (ii) VFGH had reviewed and relied on that agreement. None of that matters. Second, in addressing the priority dispute, it ignored a potential problem with attachment. That could have mattered.

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End Notes

[1] Small Business Reorganization Act (SBRA) of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified in 11 U.S.C. §§ 1181-11950) ("Subchapter V").

[2] H.R. REP. No. 116-171, at 1-2 (2019).

[3] The effective date for Subchapter V was February 19, 2020.

[4] Coronavirus Aid, Relief, and Economic Security Act § 1113, Pub. L. No. 116-136 (eff. Mar. 27, 2020)

[5] As of July 8, 2021, 2206 Subchapter V cases have been filed. *See* https://app.powerbi.com/view?r=eyJrIjoiNzJmYWJlNDQtMGNlMy00MDA5LThmZWMtODU5YTQyMDRjYWNjIiwidCI6ImI0NDBhOWMyLThjNmYtNGNlYS1iYzI1LWYzZTI0MGJjNGI1ZCIsImMiOjF9

[6] Clifford J. White III, "Small Business Reorganization Act: Implementation and Trends," ABI Journal, January 2021.
[7] Creditors whose claims are "impaired," *i.e.*, those whose contractual rights are to be modified or who will be paid less than the full value of their claims under the plan, vote on the plan by ballot. 11 U.S.C. § 1124 & 1126.