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To What Extent May a Secured Lender's Pre-Petition Covenants with a Debtor Be Modified by Cramdown Loan Documents?

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Section 1129(b) of the United States Bankruptcy Code (the "Code") empowers the bankruptcy court to confirm a Chapter 11 plan of reorganization over the objection of an impaired class of claims if the plan does not discriminate unfairly and is fair and equitable in its treatment of the objecting class; this process is generally referred to as "cramdown." Section 1129(b)(2)(A) (i) of the Code provides that an objecting secured creditor is treated fairly and equitably by a plan if (1) the creditor retains its liens to the extent of the allowed amount of the claim, and (2) the creditor receives deferred payments of a value at least equal to the allowed amount of the secured claim as of the effective date of the plan. Parties often contest whether the *Till* "primeplus" formula[1] should be applied in Chapter 11 cases, though that approach is applied as a default rule by a vast majority of bankruptcy courts.[2] However, a more interesting question is whether a secured creditor that is crammed down may retain the protections afforded by pre-petition loan agreement covenants in the post-petition relationship.

Covenants to be included in post-petition loan documents are not required to precisely track with covenants in the parties' existing loan agreement. However, modifications must be fair and equitable and must not unduly shift the risk relating to the operations and financial performance of the debtor to the secured creditor. In *American Trailer and Storage, Inc.*, 419 B.R. 412 (Bankr. W.D. Mo. 2009), the court established a balancing test to determine whether modification of pre-petition loan documents is appropriate. American Trailer & Storage, Inc. (the "Debtor") was in the business of buying, selling, renting, and leasing portable storage containers and semi-trailers. The Debtor proposed a plan of reorganization that eliminated a covenant from the original loan agreement that required the Debtor to maintain the same financial ratios that it had agreed to with Bank of the West (the "Lender") and a covenant that prohibited the Debtor from selling containers without the Lender's consent. The Lender argued that eliminating these covenants would essentially strip the Lender of its lien and result in nothing more than a naked security interest.

The court rejected the Lender's argument, and found that a determination of whether modification of loan documents is appropriate turns on (1) whether the proposed terms and covenants unduly harm the secured creditor with respect to its collateral position, and (2) whether the inclusion of terms and conditions from the pre-bankruptcy loan documents would unduly impair the Debtor's ability to reorganize. Id. at 441. In this case, the Lender had a $3 million equity cushion and there was no evidence that omitting the covenants would impair the Lender's strong collateral position. Further, including the covenants was not only likely to result in future disagreements between the parties, but would "likely doom the Debtor's reorganization." Therefore, the court approved the modification of the loan documents and confirmed the Debtor's plan.

To attack a proposed modification, a secured creditor's best argument is that the elimination of pre-petition covenants is not fair and equitable treatment as required by section 1129(b) of the Code. Courts appear to reject this argument if the lender's rights are not significantly limited under state law and the plan provides sufficient safeguards to protect the lender against the risk of plan failure. For example, in *In re Beare Co.*, 177 B.R. 886 (Bankr. W.D. Tenn. 1994), the debtors proposed a plan of reorganization that eliminated certain covenants and ratios from the loan documents, but left all security documents and debt obligations in place. Further, the debtor was required to provide the lender with monthly financial information. Under these facts, the court determined that the plan's treatment of the lender was fair and equitable.

Under certain circumstances, courts will refuse to confirm a plan of reorganization because the modifications of pre-petition loan agreement covenants would greatly increase the risk to the lender. In *In re P.J. Keating Co.*, 168 B.R. 464 (Bankr. D. Mass. 1994), the debtors proposed a plan of reorganization that modified the terms of a loan agreement to eliminate a covenant prohibiting stock redemption. The court held that while it might be appropriate to modify existing covenants between the loan parties in some instances, the resulting agreement "should not leave the lender so bare of protection as to greatly increase the risk or require a corresponding increase in the interest rate." Id. at 473. Eliminating the covenant prohibiting stock redemption would require the lender to "sit back and do nothing" as most of the redemption price, plus interest, was paid out without the debtor receiving value in return and while a large balance was still due on the lender's loan. The court determined that this treatment was hardly fair and equitable, and the elimination of that covenant alone was sufficient to prevent confirmation of the debtor's plan. If you have any questions about cramdown loan documents under the Code, please contact your Reinhart attorney or any member of Reinhart's [Business Reorganization group](#).

[1]*Till v. SCS Credit Corp*., 541 U.S. 465, 478–481, 124 S. Ct. 1951 (2004) (describing the "prime-plus" formula as the application of the prime rate of interest, or the rate charged by banks to creditworthy borrowers, as adjusted to account for the risk of default, the quality of the debtor's management, the commitment of the debtor's owners, the nature and the quality of the collateral, and the duration and feasibility of the plan).
[2]*In re Texas Grand Prairie Hotel Realty, L.L.C*., 710 F.3d 324, 336 (5th Cir. 2013).