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Determining Diminution in Value

Key Issues on Valuing Adequate-Protection Claims

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A recent dispute in the chapter 11 case of *Sears Holding Corp.*[1] over the allowance of adequate-protection claims underscores the need for bankruptcy professionals to understand the valuation of collateral in the adequate-protection context. This article focuses on certain aspects of the dispute that are relevant to understanding how courts evaluate whether a diminution in value of the secured creditor's collateral occurred.[2]

Adequate Protection

Nearly every large commercial bankruptcy case begins with the debtor seeking approval of a financing or cash-collateral order. As part of the order, the debtor's secured creditor will be provided with "adequate protection" to protect its interest in its collateral in the event its collateral decreases in value during the bankruptcy case.[3]

Although the course of a bankruptcy case is unknown at the outset, the adequate protection provided to a secure creditor might end up playing a significant role in case. If the secured creditor is oversecured at the conclusion of the case, the secured creditor will receive a full recovery and adequate protection should not be an issue. However, where the creditor is undersecured, it might seek to exercise its adequate-protection rights to obtain a recovery from unencumbered assets that would otherwise be for the benefit of unsecured creditors.

To determine whether the value of a secured creditor's collateral decreased during the bankruptcy case, it is necessary to measure the difference in value of the collateral as of two dates. The first date is typically the petition date. The second date is generally when the secured creditor asserts that a diminution has occurred (often when the secured creditor's recovery becomes known). To the extent the secured creditor's recovery is less than the initial secured claim's value, the secured creditor will generally have an adequate-protection claim for the diminution.[4]

Sears Background

Sears, an iconic national retailer dating back to 1893, faced significant business headwinds following its 2005 merger with Kmart and the rise of online retailing. At the time of its filing in October 2018, Sears operated nearly 700 stores and had approximately 68,000 employees.

Sears had significant pre-petition debt, including approximately $1.65 billion of first-lien debt, consisting mostly of an asset-based lending (ABL) facility, and approximately $1.15 billion of second-lien debt. To maintain its operations after its bankruptcy filing, Sears obtained post-petition financing that included a "roll up" of the ABL facility and a junior post-petition financing facility provided by Cyrus Capital Partners LP, a holder of Sears's second-lien debt. Significantly, the final orders approving Sears's post-petition financing, which provided for the use of the collateral pledged to the first- and second-lien creditors, did not include a waiver of Sears's ability to surcharge the second-lien collateral under § 506(c).

As part of its plan to maximize the value of its business, Sears pursued two strategies. First, it initiated "going out of business" sales for its worst-performing stores. Second, it continued to operate the remainder of its business while undertaking a

1 *In re Sears Holding Corp., et al.*, Case No. 18-23538 (RDD) (Bankr. S.D.N.Y. 2019).

2 It should be noted that the *Sears* case involves numerous complex issues, which the authors do not address in this article, and certain issues are presented in a simplified format for the sake of clarity.

3 Adequate protection might be provided in the form of cash payments (such as payment of interest), replacement liens on existing collateral, additional liens on unencumbered assets, and "other" relief that can include superpriority administrative-expense claims and payment of professional fees. *See* 11 U.S.C. § 361.

4 *See, e.g.*, Gregory A. Horowitz, Stephen D. Zide & Joseph A. Shifer, "I'm Adequately Protected; Now What? Measuring Diminution Value," XXXIII *ABI Journal* 4, 42-43, 103-04, April 2014, *available at* abi.org/abi-journal.

marketing process for either a new equity investment or a going-concern sale.

Sears ultimately accepted a bid by an entity affiliated with ESL Investments Inc., its largest equityholder and a significant holder of its second-lien debt. The bid included a cash payment of approximately $1.4 billion, subject to certain reductions (such as amounts that were credit bid by ESL and other secured creditors, including approximately $433.5 million of second-lien debt held by ESL and Cyrus). The bid also included a refinancing of Sears's first-lien debt.

Adequate-Protection Dispute

With the sale approved by the bankruptcy court, Sears then proposed a chapter 11 plan that utilized the proceeds of the sale and residual causes of action to fund creditor recoveries. The viability of the plan was uncertain because the second-lien creditors asserted adequate-protection claims that Sears did not have sufficient cash to pay.

As previously stated, in determining the extent of diminution, courts generally look at the value of the security interest as of the petition date and compare it to the recovery received by the secured creditor from its collateral. In *Sears*, the only recovery received by the second-lien creditors was in the form of their credit bid, so the dispute centered primarily on the interests of the second-lien creditors in the collateral as of the petition date. To the extent that the second-lien creditors' interest in the collateral as of the petition date was more than the amount of the credit bid, the second-lien creditors would have an adequate-protection claim for the diminution in value.

Sears claimed that there was no diminution because the value of the collateral on the petition date, less the amount of first-lien debt, did not exceed the amount of the second-lien creditors' credit bid of $433.5 million. In calculating the amount of first-lien debt, Sears included approximately $395 million in undrawn letters of credit and $34 million in accrued post-petition interest. Thus, according to Sears, there was more than $1.9 billion of first-lien debt that would need to be satisfied prior to any recovery for the second-lien creditors.

As to the value of the collateral itself, which consisted primarily of inventory and accounts receivable, Sears argued that the best indication of the collateral's value was the purchase price paid for the collateral pursuant to the court-approved sale. Sears argued that although the asset-purchase agreement did not explicitly allocate the sale consideration among the purchased assets, there was a sufficient record supporting an allocation of the cash component of the consideration to the collateral. Based on this calculation, Sears valued the collateral at 85 percent of book value (approximately $2.3 billion), which was less than the full amount of first-lien debt, and the credit bid.

Even assuming a diminution, Sears argued that all of its expenditures related to payroll, logistics, post-petition financing, rent, professional fees and other general expenses (estimated by Sears to be more than $1.4 billion in the aggregate) should be surcharged against the collateral pursuant to § 506(c), thereby reducing the amount of potential adequate-protection claims.

Not surprisingly, the second-lien holders took issue with Sears's valuation methodology. As an initial matter, the second-lien holders disputed that the baseline value of the collateral was 85 percent of book value, because the sale consideration, including cash, was not allocated in the asset-purchase agreement. Instead, the various second-lien creditors submitted expert reports that disregarded the sale as a valuation guide.

One expert relied on the collateral's book value. A second expert also used the collateral's book value but additionally calculated the margin earned by Sears by comparing the value of collateral sold during the bankruptcy and backing out the cost of selling the collateral, then used that percentage to discount the book value. A third expert applied a "net orderly liquidation value" (NOLV) for the collateral as reported by Sears pursuant to a borrowing base certificate required under the ABL facility.

With respect to the amount of first-lien debt, the second-lien holders argued that the contingent letters of credit should not be included in the calculation. As a result of the going-concern sale, the buyer had assumed Sears's obligations to the beneficiaries of the letters of credit, therefore the letter of credit would remain undrawn. Further, because the valuation was being done as of the petition date, interest that had accrued after the petition date should not have been included in calculating the amount of the first-lien debt. Finally, the second-lien holders took issue with the proposed surcharge of their collateral on the basis that many of the expenses subject to the surcharge were already reflected in the valuation of their collateral and that some of the expenses were not for their primary benefit.

Judge Drain's Decision

Following a trial on these issues, Hon. **Robert D. Drain** issued an oral ruling.[5] In determining the value of the collateral itself, he cited the U.S. Supreme Court's ruling in *Associates Commercial Corp. v. Rash*,[6] which held that courts should value assets based on their proposed use by a debtor. However, Judge Drain rejected the approach of the second-lien creditors' experts that relied on *Rash* to use book value because Sears was able to achieve a going-concern sale.

Citing Hon. **Martin Glenn**'s decision in *ResCap*[7] and Hon. **Shelley C. Chapman**'s in *Sabine*,[8] Judge Drain held that those valuations ignored the reality that assets sold as part of a bankruptcy sale suffer from an inherent impairment. Accordingly, valuations that rely on book value are "simply not tied to reality." While Judge Drain found the NOLV discount to the borrowing base formula used by one of the second-lien holders' experts to be more persuasive, he also rejected that approach because that valuation inconsistently relied on an unvetted third-party appraisal of the collateral.

Although Judge Drain found flaws in Sears's argument that the cash consideration from the sale should be allocated to the collateral, the burden of proof was on the second-lien holders to prove that they had suffered a diminution in value, and they had not carried their burden. Accordingly, he adopt-

5 Transcript of Continued Hearing on Debtors Rule 3012 Motion at 218-50, *In re Sears Holdings Corp.*, No. 18-23538 (RDD) (Bankr. S.D.N.Y. July 31, 2019).

6 520 U.S. 953 (1997).

7 *Official Comm. of Unsecured Creditors v. UMB Bank NA (In re Residential Capital LLC)*, 501 B.R. 549, 590 (Bankr. S.D.N.Y. 2013).

8 *In re Sabine Oil & Gas Corp.*, 555 B.R. 180, 200 (Bankr. S.D.N.Y. 2016).

ed a valuation of the collateral that was very close to the one proposed by Sears (*i.e.*, 86.5 percent vs. 85 percent).

With respect to calculating the amount of first-lien debt, Judge Drain also criticized the lack of evidentiary support for the notion that contingent letters of credit should not be considered as senior debt simply because they remained undrawn. Such an approach ignored the fact that even though Sears pursued a going-concern sale, there was some risk that the letters of credit would be drawn down should the case head toward a liquidation. Additional expert evidence with respect to the probability that the letters of credit would (or would not) be drawn was necessary to arrive at an expected value of the first-lien debt. Because no such evidence was submitted, the letters of credit were valued at their full face amount.

Judge Drain also ruled that the valuation of the first-lien debt should include post-petition interest that accrued during the time period that Sears conducted the sale process, as the interest would have needed to have been paid had the first-lien debt not been refinanced pursuant to the sale. To do otherwise would ignore the reality that it is impossible to instantly realize the value of the collateral on the petition date. Therefore, interest that accrued during the time needed to realize the hypothetical value as of the petition date had to be included in the calculation of senior debt.

Finally, Judge Drain found that Sears was not entitled to a § 506(c) surcharge. Because the sole evidence before him was a summary table of incurred expenses, and due to the fact that a debtor has the burden of proof to establish whether a surcharge is appropriate, Judge Drain found that there was no basis to determine whether some of the costs were already reflected in the valuation of the collateral or even whether the expenses were incurred for the benefit of the second-lien holders. Based on Judge Drain's ruling, the parties settled on an order that found that there was no diminution in value to the second-lien creditors' collateral.[9]

Conclusion

Judge Drain's decision demonstrates that courts are increasingly willing to craft flexible valuation methodologies that are not rooted in dogmatic formulas but are instead reflective of reality. The focus on substance over form means that parties engaged in an adequate-protection dispute need to tailor their litigation strategies to better reflect the circumstances in which adequate protection was provided. In particular, a party seeking to assert an adequate-protection claim must account for the inherent impairment of a debtor's assets.

It is also significant that in both instances where the party had the burden of proof, *i.e.*, the second-lien holders on the adequate-protection claim and Sears on the surcharge issue, Judge Drain ruled against that party as a result of a failure to carry its burden. Valuation is, by its nature, a fact-driven analysis, and all parties should meticulously prepare their evidentiary support for their respective positions.

Finally, although Sears failed to carry its evidentiary burden on the surcharge pursuant to § 506(c), the case remains a cautionary tale for secured creditors that are unsuccessful in obtaining a waiver of the surcharge at the outset of the case. Had Sears met its burden, the surcharge could have reduced the amount of any adequate-protection claim received by the second-lien holders. **abi**

9 The ruling is currently on appeal to the district court by both the second-lien creditors (in respect of the denial of their adequate-protection claims) and by the creditors' committee (in respect of the denial of the surcharge).

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