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Are Lenders Becoming Less Concerned About Lender Liability?

By Adam Schlagman

Work for bankruptcy counsel over the past few years has not been limited to representing parties in Chapter 11 cases. A significant amount of time for many has been spent advising clients on how to deal with loans that are currently in default, but which are not being actively prosecuted by lenders. In these scenarios, parties are operating in a state of limbo, for better or worse.

Phrases like "extend and pretend" have been heard countless times over the last few years when talking about a bank's proclivity not to deal with troubled loans in its portfolios. Countless are the stories of borrowers who simply could not get their lender to engage in a dialogue about how to work out a troubled loan. States of paralysis like this do not last forever, and my market intelligence indicates that, it has already started to break.

In the last few quarters, bank workout groups have started to recover from, and reinforce their ranks in response to, the tsunami of activity that began to besiege them several years ago. And, since much of this reinforcing was necessitated by massive layoffs, it appears that many of the loan officers responsible for making the bad loans in the first place are no longer employed by the particular lender. In addition,

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Foundations of a Successful Homebuilder Reorganization

An Inside Look at Orleans Homebuilders, Inc.

By Joel H. Levitin, Maya Peleg, Mitchell B. Arden and Michael P. Gaul

Orleans Homebuilders, Inc. (together with its affiliates, "Orleans"), designs, markets, develops, and builds high-quality, single-family homes, townhomes, and condominiums to serve various types of homebuyers. Orleans has been in business since 1918 and currently operates in Southeastern Pennsylvania; Central and Southern New Jersey; Orange County, NY; Charlotte, Raleigh, and Greensboro, NC; Richmond and Tidewater, VA; and the Chicago suburbs. Florida-based operations were closed last year.

Orleans designs its homes with the assistance of unaffiliated architectural firms, and it supervises the development and building of its communities. Orleans acts as the general contractor for its homes, and employs subcontractors at specified prices for the installation of site improvements and construction. The company owns approximately 3,600 buildable lots in various stages of development.

The Downturn

Beginning in 2006, Orleans, along with the entire U.S. homebuilding industry, experienced a significant and sustained downturn, characterized by decreased demand for new homes, an oversupply of both new and resale home inventories (including homes under foreclosure), a decline in average selling prices, and aggressive competition among homebuilders. The decrease in demand for new homes was exacerbated by the global credit crisis, which made traditional mortgages more difficult to obtain, and their terms and pricing more onerous.

Although Orleans' net debt decreased by $164 million, and it significantly reduced homes built on speculation, total lots owned and controlled, and employee head count from fiscal year 2006 to 2009, its revenue dropped from $987 million to $330 million, and its pre-tax income declined from $65 million to negative $160 million, during that period.

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These internal challenges, combined with continued turmoil in the credit markets throughout fiscal year 2009, adversely affected Orleans' continued access to needed financing. Despite obtaining several amendments and extensions of its original $650 million secured credit facility to address various financial covenant defaults and related matters, the loan matured on Feb. 12, 2010, and Orleans was unable to obtain the 100% consent of the 17-member lender group necessary for a maturity extension. At that point, Orleans did not have sufficient liquidity to continue normal operations. Among other problems, the company struggled to pay suppliers to complete homes and release lien and other claims, so its business essentially ground to a halt. Ultimately, Orleans' lenders indicated that they would provide continuing financing only in the context of a bankruptcy filing culminating in a prompt sale of substantially all of its assets.

Chapter 11

After negotiating debtor-in-possession (DIP) financing with a group of its existing lenders to provide Orleans with the liquidity necessary to market and sell its business, on March 1, 2010, Orleans (59 affiliated entities) commenced Chapter 11 bankruptcy cases in the United States Bankruptcy Court for the District of Delaware, and the cases were assigned to the Honorable Peter J. Walsh and docketed as *In re Orleans Homebuilders, Inc.*, Chapter 11 Case No. 10-10684 (PJW) Jointly Administered (Bankr. D. Del.). Pleadings and other information regarding the bankruptcy cases can be accessed at www.orleanshomesreorg.com.

As of the commencement of the bankruptcy cases, Orleans had approximately $311 million of borrowings outstanding under its credit facility, excluding letters of credit, approximately $120 million of trust preferred secured and related debt outstanding, and approximately $45 million of unpaid trade debt, including numerous mechanics' lien claims.

The DIP Facility

Orleans' $120 million DIP facility permitted it to use cash collateral and provided $40 million of incremental availability in the form of a revolving loan facility, including letters of credit, and $80 million of "roll up" term loans of portions of the indebtedness under the pre-petition credit facility (one tranche for participants in the DIP loan and another for the lenders that did not oppose court approval of the DIP loan). All of the obligations under the DIP facility were granted super-priority administrative expense status and were secured by first-priority liens upon substantially all of Orleans' assets (other than avoidance actions). However, the DIP liens were subject to valid and unavoidable liens that were entitled to priority under applicable state law (*e.g.*, certain mechanics' liens).

In addition to the usual restrictive bells and whistles, the DIP imposed various milestones on Orleans, such as requiring completion of a sale of substantially all of its assets by July 5, 2010, or confirming a plan of reorganization by July 30, 2010, and required the appointment of a Chief Restructuring Officer. The DIP also required Orleans to procure warranty insurance for all homes sold post-petition and prohibited new construction except on properties where the foundation and footing were already completed. In short, the DIP enabled Orleans to maintain and operate its business in the short-run on a relatively tight leash to give it a chance

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CMBS Certificate Holders Denied Standing in *Innkeepers*

By Grant L. Cartwright and Ryan J. Dattilo

In one of the first decisions of its kind, the United States Bankruptcy Court for the Southern District of New York, in *In re Innkeepers USA Trust, et al.*, 2011 WL 1206173 (Bankr. S.D.N.Y. Apr. 1, 2011) ruled that a holder of commercial mortgage-backed securities ("CMBS") did not have standing to raise objections as a party-in-interest in a bankruptcy case. The case has significant implications for investors of commercial mortgage-backed securities involved in bankruptcy proceedings.

Factual Background

Innkeepers USA Trust ("Innkeepers" or the "Debtors") is a real-estate investment trust that owns and operates a portfolio of 72 hotels across the United States. Its capital structure includes $1.29 billion of secured debt consisting of: 1) a securitized mortgage loan in the amount of $825 million (the "Fixed Rate Loan") with Lehman ALI Inc. as the lender ("Lehman"), collateralized by 45 of the Debtor's hotel properties; 2) a floating rate senior mortgage loan in the amount of $250 million, collateralized by 20 of the Debtor's hotel properties; 3) a mezzanine loan in the amount of $118 million; and 4) seven loans, each separately securing individual hotel properties ranging in amount from $24 million to $48 million. The Fixed Rate Loan was held in two CMBS trusts (the "CMBS Trusts"), which were serviced by Midland Loan Associates ("Midland"). Appaloosa Investment Fund L.P. I, and other related entities (collectively, "Appaloosa") held more than $200 million in principal amount of CMBS certificates in the CMBS Trusts. Following defaults on several of its loan obligations, the Debtors filed for bankruptcy protection in July 2010.

After the bankruptcy court denied approval of the Debtors' first restructuring proposal, the Debtors filed a motion (the "Motion") for approval to enter into an equity commitment agreement with Five Mile Capital II Pooling REIT LLC ("Five Mile") and Lehman (the "Five Mile/Lehman Bid"). The Five Mile/Lehman Bid contemplated an enterprise-level transaction involving the Debtors' entire portfolio of hotels and a reduction of the Debtors' overall debt by approximately $750 million. Specifically, the principal amount of the Fixed Rate Loan would be reduced from $825 million to $622.5 million. Midland, as servicer, agreed to the reduction on behalf of the CMBS Trusts. Also as part of the Five Mile/Lehman Bid, Midland agreed to provide staple financing to fund the Five Mile/Lehman Bid or any other qualified bid at the auction that contained a debt-to-capitalization ratio for the reorganized enterprise of not greater than 70% and provided for a payment to Lehman of not less than $200.3 million in cash.

Several parties filed objections to the Motion, including: 1) the Ad Hoc Committee of Preferred Shareholders; 2) LNR Securities Holdings, LLC and ML-CFC 2006-4 and CSFB 2007-C1 Trusts; 3) TriMont Real Estate Advisors, Inc.; 4) Appaloosa; 5) CWCapital Asset Management LLC and CIII Asset Management LLC; and, 6) the Official Committee of Unsecured Creditors. By the time of the hearing on the Motion, the Five Mile/Lehman Bid had been revised, and all objections other than those of Appaloosa had been withdrawn.

Appaloosa contended, *inter alia*, that the bidding procedures impeded competitive bidding and that they improperly mandated terms of a plan of reorganization. The Debtors and Midland argued that Appaloosa lacked standing as a certificateholder to object to the Motion. Appaloosa argued that a "party in interest" under § 1109(b) of the Bankruptcy Code should be interpreted broadly, and that § 1109(b) conferred rights on it sufficient to permit it as a "party in interest" to participate in the case and protect its financial stake.

The Bankruptcy Court's Ruling

The bankruptcy court began with an analysis of § 1109(b) of the Bankruptcy Code, which provides that "[a] party in interest … may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b). The bankruptcy court determined that in the Southern District, courts have been reluctant to find that a "party an interest" may extend beyond direct parties. In previous cases, courts held that while a creditor of one of the debtor's creditors may be "deeply concerned about the bankruptcy proceeding … the party's legal rights and interests can only be asserted against the debtor's creditor, not against the debtor … ." *Southern Blvd., Inc. v. Martin Paint Stores*, 207 B.R. 57, 61 (S.D.N.Y. 1997).

The court then proceeded to examine two cases that, despite not being directly on point with the CMBS/REMIC standing issue, provided persuasive guidance. The court first looked to *In re Shilo Inn*, 285 B.R. 726 (Bankr. D. Or. 2002). In *Shilo Inn*, the court denied standing to certificate holders of pooled real estate loan trusts. The court rejected the debtors' attempt to allow certificate holders of certain trusts to vote on a proposed plan, finding that any claims against the debtors belonged to the trusts as creditors, and not the certificate holders. Looking at the actual language of the pooling and servicing agreement, the court determined that the trust was the party that had the right to vote. The court made a key distinction between a corporate bond and a securitization, noting that in the case of a corporate bond, the bondholder has a

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right to payment from the corporation, whereas in a securitization, the certificate holder's right to payment is generated from the underlying assets, not the originator of the assets themselves.

The second case the court looked to was *Krys v. Official Comm. of Unsecured Creditors of Refco, Inc.* (*In re Refco, Inc.*), 505 F.3d 109 (2d Cir. 2007), in which the Second Circuit held that an investor of a creditor is not a "party in interest" within the meaning of § 1109(b). In its decision, the Second Circuit determined that investors in a nondebtor segregated portfolio company ("SPC") did not have standing to object to a settlement between the SPC and the official committee of unsecured creditors. The investors had placed control over their investment in the hands of the SPC, and, thus, their rights were purely derivative of the SPC's.

Following the reasoning by the courts in *Shilo Inn* and *Refco*, the court examined the terms of the CMBS Trusts and concluded that Appaloosa was merely an investor in a creditor and did not possess "party in interest" standing in its capacity as a certificate holder. In reaching this conclusion, the court noted that this was not the first time Appaloosa had attempted to circumvent a pooling and service agreement in order to override the actions of a CMBS special servicer. In *Bank of America, N.A. v. PCV ST Owner L.P.*, Case No. 10-1178 (S.D.N.Y.) ("*Stuytown*"), Appaloosa, a certificateholder of the CMBS trust in those cases, sought the right to intervene in a foreclosure action against the borrower of a securitized mortgage loan. The district court summarily denied Appaloosa's motion to intervene, which lent further support to the court's decision to deny Appaloosa standing in the instant case.

The basic conclusion of the court was that Appaloosa lacked privity with the Debtors sufficient to confer standing to be heard. In a securitization, as pointed out by the court in *Shilo Inn*, the investor's relationship with the special purpose vehicle holding the assets, and the right to payment, comes from the cash generated by the assets, not from the debtor as the originator of the assets themselves. Taking special note of the distinction made in *Shilo Inn* between bondholders and certificateholders, the court found that unlike bondholders who have a direct interest in the obligations of the Debtors, certificateholders' interests are limited to the assets of the trusts. Therefore, Appaloosa, as a certificateholder, did not have any direct interest in the obligations of the Debtors. Only the trusts themselves were creditors of the Debtors.

The court proceeded beyond the privity argument for denying standing and examined Appaloosa's failure to follow the "no action" clause of the servicing agreement. The "no action" clause prohibited a certificateholder from instituting any suit, action, or proceeding unless specific conditions were met. The court found that none of the conditions precedent to "action" had been met, and therefore Appaloosa was unable to surpass the CMBS special servicer and assert independent standing.

Despite Appaloosa's assertions that Midland was engaging in conflicted and self-enriching behavior, the court avoided making any specific determinations of misconduct. Citing the Second Circuit in *Refco*, the court emphasized that the place for disputes between a creditor and its investors was not in bankruptcy court. If Midland was acting improperly, then Appaloosa possessed the option of pursuing its contractual remedies in another forum. The court found that the "servicing standard" to which a servicing agent is contractually bound provided a sufficient "check" on the agent's conduct, and therefore did not require the involvement of the bankruptcy court.

Finally, the court emphasized certain policy concerns, stating that granting standing to certificateholders such as Appaloosa would "dramatically alter the CMBS landscape and render the delegation to a special servicer meaningless." *InnKeepers*, 2011 WL 1206173 at *19. In particular, the court feared that such challenges to the special servicer's authority would permit investors like Appaloosa with "its varied holdings" to "pursu[e] its own pecuniary interests which may be at odds with the interests of other certificateholders." *Id.* Despite its focus on the policy issues concerning the standing of certificateholders of CMBS, the court reiterated that it's ruling was "based entirely on controlling law as well as the applicable language of the servicing agreement." *Id.* at *20.

Despite denying Appaloosa standing to be heard and object to the Motion, the court evaluated their substantive objections. Applying the standards applicable to a 363-sale motion in the Second Circuit, the court granted the Debtors' motion.

Implications of the Court's Decision

At first glance, it would appear that the court's decision in *Innkeepers* has set a strong precedent barring certificate holders in CMBS transactions from asserting standing in a related bankruptcy case. While it has surely stacked the deck against certificate holders, there may still be opportunities for future certificate holders to assert standing.

One of the more interesting aspects of the court's decision was the determination that Appaloosa was bound by the "no action" clause of its servicing agreement. After examining the court's decision, it appears unclear whether the door has been left open to certificate holders who were capable of establishing the conditions required under a "no action" clause.

The court does not give a strong indication of whether Appaloosa could have overcome its absence of privity with the Debtors by establishing the necessary conditions precedent for "action." It only states that none of the conditions had been met "such that Appaloosa [was] entitled to circumvent the special servicer and be afforded independent standing to be heard on its motion." *Id.* The court determined that Appaloosa failed to make any notice of default to Midland or acquired the necessary 25%

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of voting rights. With a bit of cleverness and the appropriate foresight, these are things that certificateholders can easily avoid.

Assuming that fulfillment of the "no action" clause is sufficient to overcome the certificate holders' lack of privity with the debtor, there still may be an issue regarding the court's policy concerns. As stated previously, the court expressed concern about individual certificate holders with other varied holdings pursuing interests at odds with the interests of other certificate holders. These same concerns were recently considered in the enactment of the amendments to Rule 2019. The fear of an "empty creditor" within a specific class or committee is almost identical to what could be referred to as an "empty certificate holder" within its group of other certificate holders. Just as the recent changes to Rule 2019 were passed to alleviate the risks posed by the "empty creditor," it is plausible that these changes could also alleviate the court's concerns over certificate holders with varied other holdings.

Conclusion

In summary, while *Innkeepers* decidedly limited the standing of investors in certificates representing beneficial interests in trusts holding mortgage-backed securities, it does not appear to be a complete limitation. Such investors should now be on notice that if they hope to effectively argue standing, they must complete the necessary trust agreement requirements, such as a "no action" provision.

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there are surely other reasons for the recent increase in dialogue, such as FDIC loss-sharing agreements, which certainly make write-downs more palatable. Regardless of the reasons, however, defaulted loans are less likely to be extended today than they were even one or two quarters ago — at least based on the evidence I have seen.

Deal Makers' Summit

This was one of hot topics discussed recently at the third annual Deal Makers' Summit, a private event I recently had the pleasure of attending, hosted by Chicago law firm Levenfeld Pearlstein LLC, and the boutique special situations advisory group, Fuel Break Capital Partners, Weston, CT. The attendees of this event were primarily private equity fund principals from the middle and lower middle market, where both deals and workouts tend to be more on the aggressive side. Nevertheless, many of the shared experiences and observations were instructive.

One recurring theme at the Summit was that current circumstances are not necessarily making bankers any less conservative in dealing with the troubled loans in their portfolios. Despite their pre-meltdown behavior, bankers are by nature an orthodox group. They have their protocols, processes and procedures. A banker who strays from the standard protocol in dealing with a problem loan, according to some, stands a better chance of getting fired. And so, many of the participants expressed a view that there is a dominant mind among bankers: "Why place yourself at risk to rescue a transaction that's already been written off?"

Mark Horita, a managing director at The Peakstone Group, Chicago, stated, "I do think that relative to pre-recession timeframes that some of the overly loose practices have come back to a more conservative approach. That said, the banks are experiencing a dramatically more conservative oversight environment, which forces them to probably be more conservative than they would be otherwise. To dig a little deeper, on the lending side, the relationship managers that we know are getting a fair amount of pressure to find lending opportunities. However they're working with credit officers who find themselves in the tough position of having to balance the pressure of trying to put money to work (and increase profits) with increased regulatory scrutiny … and also in some cases, still cleaning up their balance sheets."

A Different Perspective

Not everyone, however, shared the view that banks are becoming more conservative in their dealing with troubled assets.

One turnaround adviser, who asked to remain anonymous for obvious reasons, was a bit more blunt: "I've negotiated about a dozen workouts of underwater loans in the past year or so and never in my career have I seen workout guys I've liked less. Across the board, my experience is that the banks are going out of their way to hire guys who seem to have no soul." To be fair, since the Deal Makers' Summit is attended primarily by private equity participants rather than lenders, the views expressed at the event were clearly biased toward the company perspective.

Jonathan Friedland, a Levenfeld partner and restructuring attorney with a focus on working with private equity funds and their troubled portfolio companies, put it more sanguinely. According to Friedland, "the trend is unmistakable. Traditional lenders are getting more and more comfortable using the same sort of creative and aggressive tactics which, until recently, I had seen only loan to own players use."

Others agreed. Brian Boorstein, a Managing Partner at Granite Creek Partners, Chicago, an opportunistic PE fund, said: "historically, when we work with troubled companies, we see an opportunity to take out or work in concert with the incumbent lender and make a spread between what the it can realize from its collection efforts and what we can realize through financial sponsorship and leadership. Our role, which emanates from rights that are generally afforded to those in a senior security, includes investing additional capital, hiring or firing of senior management, or catalyzing changes in the business model. Suffice it to say, we have the same tool boxes but funds like us have been far more likely to be actively involved."

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Friedland clarified: "I've been involved in hundreds of deals where the loan documents permitted a lender to remove a company's board and replace it with one of its own choosing. But, until 2009, I had never been involved in a deal where a bank — as opposed to a non-traditional lender, like a fund — had actually exercised the right. Since 2009, I've been involved in several. My point is that banks are beginning to cross a line they never used to cross. They are starting to use the sort of strategies Brian has been using for years."

Rich Bochicchio, a principal of Stamford, CT-based Seaward Partners, LLC, acknowledged the trend, but had a slightly different spin: "Things cycle, and right now bankers are being more aggressive, but it won't last. The young hotshots who were brought into the banks to resolve troubled situations that were already reserved for will move on, will generate new loans, and will eventually be asked to work out their own mistakes. As a buyer of troubled assets, do I have to work harder now? Sure. But am I still willing and able to do things that banks just can't or won't do? You bet."

Bill Schwartz, a Levenfeld partner who represents a number of banks and other lenders in workout situations, confirmed the sentiments of others by saying "it isn't surprising, really, that banks are becoming more aggressive. Lender liability suits have never been easy to prevail upon. Because loan-to-own players have been very aggressive with a fair amount of success, it was only a matter of time before we started seeing some lenders try to adopt similar tactics."

Others in the room did not necessarily agree. Matt Zakaras, a principal of Echelon Capital, Chicago, pointed out that because this tactic is unconventional among bank lenders and perhaps even unchallenged, it is not without risks: "I'm aware of a few cases where a lender has removed a board in this manner, but I am not aware of anyone then challenging the exercise of that right. Until there is a substantial body of case law supporting it, traditional lenders and their advisers will be slow to adopt the strategy."

Conclusion

Regardless of whether this one particular strategy is being employed with more frequency, one feeling in the room was clear: The line between traditional and non-traditional lenders is blurring. One consequence of this is that traditional lenders seem less willing to take haircuts when they see another way out. As the old adage goes, some companies that — a year or two ago — just wanted their lender to come to the table, may find themselves being sorry for what they wished for.

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to effectuate a prompt sale transaction.

Summary of Challenges Faced by Orleans

The early focus of the bankruptcy cases was on dealing with challenging issues required to restore operations and to minimize continuing disruption to the business to enable Orleans to maintain (and enhance) its enterprise value until a sale transaction could be completed. In addition to the transition and related matters confronted in most bankruptcy cases, such as paying pre-petition employee wages, salaries, and benefits, paying pre-petition taxes, and maintaining its cash management system, as a homebuilder, Orleans had some unique issues that needed to be addressed immediately upon filing.

Most importantly, and as the result of significant pre-petition liabilities, including mechanics' liens, Orleans faced some serious impediments to closing on the sales of homes, the primary source of the company's revenues. For example:

- Would Orleans be able to sell homes free and clear of liens, claims, encumbrances, and other interests?
- Would title insurers continue to issue title insurance?
- Would home warranty providers continue to provide warranties?
- Would vendors and subcontractors return to building sites and provide reasonable terms?

By meeting these challenges and anticipating and addressing operational issues before they escalated, including by launching a communications program targeted at its major constituencies, Orleans was able to revive its business. Some of the other major obstacles overcome by Orleans during its bankruptcy cases included maintaining surety bonds posted to backstop community development obligations; providing appropriate incentives to its employees to maintain their dedication and support; and enforcing the automatic stay against parties that had utilized self-help to "reclaim" building material, among other things, but those issues are beyond the scope of this article. Orleans was able to generate significant value, which enabled it to negotiate a plan of reorganization that garnered the support of all major constituencies (the landscape shifted and a sale was no longer mandated).

Selling Homes in Bankruptcy

As mentioned above, the sale of homes by Orleans on a post-petition basis was critical to the success of any exit strategy. In most businesses, the sale of "inventory" in the ordinary course of business does not require any bankruptcy court involvement. However, for Orleans, given uncertainty of various parties involved in the home sales process, the potential lien rights of vendors and subcontractors, and other issues, the ability to obtain court relief was crucial.

Under the law of most states, construction vendors and subcontractors typically have the right to assert mechanics' liens or other statutory or common law liens (collectively referred to herein as "operational liens") against the property on which they worked, and in certain states, such operational liens can prime prior secured debt. First, because

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the lenders' liens typically pre-dated construction, in six of the eight states in which Orleans operated, the purported operational liens generally did not prime the liens of the pre-petition lenders. However, in Virginia and Illinois, many such claims were senior to those of the lenders, at least partially, under state law. As discussed above, such rights were preserved under the DIP. Second, because the estimated value of Orleans' assets was less than the amount outstanding under the pre-petition credit facility, such priming liens were the only operational liens that constituted secured claims; all other operational liens constituted unsecured claims. *See* 11 U.S.C. § 506(a)(1) ("[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property … and is an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim.") Rather than presenting a valuation of Orleans' assets and an analysis of the relative priorities of each of the many claims against Orleans' properties at the outset of the bankruptcy cases, Orleans sought to establish procedures for the resolution of all claims that would preserve all parties' rights, while at the same time permitting home sales to close.

Thus, on the petition date, Orleans filed a motion to authorize it to contract for, and close on, sales of homes, to honor customer deposits (which were held in escrow accounts) and other contractual obligations, to sell homes free and clear of all liens, claims, encumbrances, and other interests, to establish procedures for the resolution of lien and other claims, and to use proceeds of home sales in accordance with certain lien procedures. Following the first-day hearings, the bankruptcy court entered an interim order permitting Orleans to close on sales of homes, to honor customer deposits, and to sell homes free and clear. Any operational liens the parties had (if any) would attach to the proceeds of the applicable sale (and could be paid out of any available funds) or would attach to the proceeds of the sale(s) of Orleans' remaining assets, in either case, with the same priority as such operational lien was entitled to under applicable state law. The issue of procedures for dealing with the resolution of operational liens was deferred until a later hearing.

While selling homes pursuant to the interim order, Orleans worked with title insurers, vendors and subcontractors, and other parties-in-interest to resolve their objections to these proposed procedures. Orleans faced significant resistance, largely from the holders of operational liens because, unlike many homebuilder bankruptcy cases where vendors' claims are paid in full, Orleans insisted on reserving the right under § 363(f) of the Bankruptcy Code to strip the liens of under-secured operational lien holders.

Certain operational lien holders argued that the court should force Orleans to escrow home sale proceeds sufficient to satisfy outstanding claims, but such a requirement would have constrained liquidity and create unnecessary administrative burdens, particularly given the lenders' agreement that holders of valid, non-avoidable, priming liens would be paid out of the proceeds of a particular sale or, alternatively, out of the proceeds of any sale outside of the ordinary course of business (*e.g.*, the contemplated sale of the business). After numerous discussions, the filing of competing orders by various parties, and no less than three contested hearings, a final order proposed by Orleans was entered by the court on April 15, 2010, establishing procedures requiring Orleans to provide notices of closings for each sale, which triggered a deadline for each purported operational lien holder to file a written demand for payment, including evidence that it was entitled to a valid and unavoidable lien with priority under applicable state law over the pre-petition and DIP lenders, and establishing procedures for the parties to resolve or litigate a resolution of such demand. All but a few of such claims were resolved without the need for any court intervention.

Although Orleans had authorization from the court to sell homes free and clear, and recorded the final order of the court in each jurisdiction in which it was selling homes, the individual agents dealing with the issuance of title insurance (and the closing attorneys for many of the purchasers) were unfamiliar with such an order and the bankruptcy process in general. Thus, Orleans worked closely with the individual agents (and closing attorneys), largely by explaining the protections afforded by the order, and providing affidavits of service demonstrating that each holder of a lien listed on the title reports had been served with notice of the bankruptcy cases. In one instance, Orleans even filed a motion after the closing of a sale to compel the release of liens that had been filed in contravention of the order. Within a relatively short time, Orleans was able to alleviate title insurers' concerns and was able to close homes with minimal, if any, delay. The success of these efforts is evident by the fact that Orleans was able to close on sales of approximately 390 homes during the bankruptcy cases, generating related aggregate sale proceeds of approximately $150 million.

Orleans received, reviewed, and responded to several hundred demands for payment in accordance with these home sales procedures. To the extent that holders of valid, non-avoidable, priming operational liens complied with the procedures, they were paid in full. Orleans paid 36 claimants approximately $1.1 million pursuant to the home sales procedures, and 19 claimants approximately $0.2 million pursuant to its plan of reorganization on account of such secured claims.

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Any other purported liens were deemed satisfied, discharged, null and void, and of no force and effect by Orleans' plan of reorganization. Orleans estimates that it resolved a total of approximately $40 million of purported operational lien claims. The holders of any such allowed claims will receive distributions as general unsecured creditors under the confirmed plan.

Continuing Warranties

Shortly after Orleans obtained interim approval to sell homes, one of its largest warranty providers refused to issue post-petition warranties because of uncertainty regarding its exposure going forward. Without access to warranties, Orleans would have been unable to sell homes because it was required in many jurisdictions to provide warranties to all homebuyers (without knowing it would be around to honor them), and the DIP financing facility required Orleans to obtain (and provide) warranty insurance for all homes sold after the petition date.

Orleans moved quickly to resolve the issues with its existing warranty provider and to seek out an alternative source for warranties to ensure that operations were not interrupted. Ultimately, Orleans was able to reach an agreement with the warranty provider, whereby a modest agreed-upon amount of money was placed in escrow for each post-petition closing, and Orleans reserved its right to assume or reject the related agreements.

Managing Vendors

Also integral to the continuity of Orleans' operations was access to reasonably priced goods and services (as discussed above, Orleans subcontracts all of the construction of its homes), necessitating the preservation of relationships with its vendors. Originally, Orleans obtained emergency authorization to pay up to $7.5 million of critical vendor pre-petition claims (later raised to $10 million).

Orleans negotiated for go-forward credit terms with a select group of vendors and ultimately paid $2.57 million to approximately 49 critical vendors on account of pre-petition obligations. On average, Orleans paid approximately 34% of each critical vendor's pre-petition claim. The structure of the critical vendor program allowed Orleans the leverage and flexibility to obtain the most favorable credit terms available at the lowest possible cost.

The Sale Process and the Change of Focus to a Stand-Alone Restructuring

Although Orleans had explored sale opportunities prior to bankruptcy and was in contact with various potential buyers, it had not yet reached an agreement with any particular buyer as of the petition date. Because of the expedited schedule required by its DIP facility, Orleans promptly negotiated the terms of a $170 million "stalking horse" asset purchase agreement, subject in all respects to Bankruptcy Court approval, and, on April 13, 2010, filed a motion to approve sale procedures and bid protections and scheduling an auction and hearing to consider approval of the sale.

Prior to any hearing on the motion, certain parties (that by such time had accumulated approximately 80% of the DIP and the pre-petition secured debt) expressed a willingness to pursue negotiations of a stand-alone plan of reorganization. After negotiating certain modifications of its DIP facility designed to give Orleans more flexibility in its operations (including allowing it to advance construction of lots that were in their initial stages, increasing the DIP revolver sub-limit, increasing the amount of permitted variances from the DIP budget, and extending various deadlines), Orleans was able to shift from a strategy of merely preserving value for a quick sale toward a longer-term, go-forward business plan and reorganization. On May 19, 2010, Orleans withdrew the sale motion to pursue a plan.

First, Orleans negotiated a plan with its lenders providing for new money or restructured loans to address a portion of the lenders' claims and for the remainder of their claims to be provided equity in the reorganized company. Then, prior to the hearing on the disclosure statement relating to such plan, Orleans brokered a deal between the lenders and the unsecured creditors' committee, whereby unsecured creditors will share in a distribution pool that is meaningful in light of the minimal unencumbered assets that were otherwise available for distribution to unsecured creditors. All along the way, until the confirmation hearing was concluded, Orleans dealt with concerns raised by numerous of its creditors and consensually resolved (or at least deferred) all of them.

Conclusion

In sum, Orleans' ability to utilize the Chapter 11 process to jump-start the business and restore relationships with customers, vendors, and subcontractors, among others, created significant value that was clearly evident and likely one of the reasons that the company's lenders decided to support a stand-alone plan of reorganization. Because Orleans was able to address potential obstacles before they derailed the business, it was able to negotiate and confirm a plan of reorganization (at a virtually uncontested confirmation hearing) just nine months to the day after the commencement of the cases and to emerge from Chapter 11 shortly thereafter (Feb. 14, 2011) as a private company with stronger operations and a healthier balance sheet.

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