
DIP Financing and Cash Collateral: Too Much Control for the Lenders?

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In the wake of the most recent credit crisis which began in the fall of 2008, banks and financial institutions have been openly, and perhaps justifiably, criticized for contributing to one of the worst global economic downturns as a result of having provided financially unfit borrowers with “easy credit” and not taking adequate measures to ensure the repayment of this debt. While the days of easy credit appear over for now, in the realm of debtor-in-possession (“DIP”) financing, lenders have almost always required various and extensive protections that are designed to maximize the prospects of full repayment.

Indeed, the majority of DIP credit facilities proposed in Chapter 11 cases are governed by lengthy financing orders and credit agreements containing various provisions aimed at affording DIP lenders with substantial “control” over the maintenance, use and disposition of their collateral, which in bankruptcy is the primary source of the DIP lender’s repayment. Typically, a well-drawn financing order and DIP credit agreement will include provisions requiring a Chapter 11 debtor to sell some or all of its assets within a specified time frame, maintain certain financial bench marks or operate within a budget, expanded events of default, “roll-ups”, releases of potential claims against the DIP lenders and provisions granting DIP lenders automatic relief from the automatic stay upon the occurrence of an event of default. Additionally, to compensate the Chapter 11 lender for the use of its funds and its risk, DIP credit facilities usually contain an additional layer of financing fees (commonly referred to as DIP facility fees) as well as a slightly higher rate of interest as compared with financing facilities of similar companies not in Chapter 11.

Recently, some courts and commentators have suggested that these “pro-DIP lender” provisions substantially impair the Chapter 11 debtor’s ability to successfully reorganize its business, as the implementation of these provisions lead to the debtor promptly conducting an

orderly liquidation of its assets in order to fulfill its contractual obligations to its DIP lender. Numerous bankruptcy courts across the country have established local DIP financing guidelines which characterize many of these DIP provisions as “extraordinary” relief requiring additional scrutiny before a Bankruptcy Court will approve them as part of a DIP credit facility (although these DIP financing guidelines generally have not chilled the extent to which these pro-DIP lender provisions are being approved by Bankruptcy Courts).

The tide of liquidating Chapter 11 cases has risen in the last few years, and with increased efforts by lenders to enhance the likelihood of a successful recovery, a minority of courts and commentators have sought to limit, if not completely eliminate, the ability of DIP lenders to protect their rights and interests in the collateral by disallowing these lender-friendly DIP financing provisions (see, e.g., In re The Colad Group, Inc., 324 B.R. 208 (Bankr. W.D.N.Y. 2005); In re First Magnus Financial Corporation, Case No. 4-07-bk-01578 (Bankr. D. Ariz. August 21, 2007); and Testimony of Harvey R. Miller before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, 111th Congress, 1st Session, March 11, 2009).

However, these DIP lender-friendly provisions, many of which have been a part of the DIP financing “form” documents for years, are only a manifestation of the underlying problem of the distressed company, rather than the cause. Without a pre-arranged or pre-packaged agreement among the debtor and the debtor’s secured, undersecured and unsecured creditors providing for the mechanics of a reorganization in Chapter 11 *in advance* of the bankruptcy filing, prospective Chapter 11 debtors with little or no equity in their assets and/or lackluster business prospects have virtually no hope of obtaining “offensive” or “new money” DIP financing in today’s credit market that will enable the debtor to reorganize. Thus, limiting the

protections afforded a lender by virtue of the DIP financing orders will not, in and of itself, level the playing field.

For example, as many commentators have already noted, the 2005 Bankruptcy Code amendments have adversely impacted the ability of Chapter 11 debtors, especially retail debtors, to utilize Chapter 11 to rehabilitate their businesses and successfully reorganize. The amendments have reduced the bankruptcy court's discretion to extend critical deadlines and shortened the timeframe in which the Chapter 11 debtor can enjoy the uninterrupted benefits of Chapter 11. However, even more damaging to the prospects of successful reorganizations is the fact that most companies entering Chapter 11 today have few, if any, unencumbered assets and little or no enterprise or going concern value available to provide the basis for additional financing, and hence there is no "market" for competitive, debtor-friendly financing arrangements that would enable the debtor to reorganize.

Having been the beneficiary of the "over-heated" credit markets which existed a few years ago, prospective Chapter 11 debtors are often over-leveraged (typically including various layers or "tranches" of secured debt, a large portion of which is oftentimes undersecured at the time of the bankruptcy filing) and have very little to offer potential lenders in consideration for obtaining a true working capital, "new money" DIP credit facility. Moreover, many lenders in the market to provide DIP financing have sustained unprecedented losses from failed loans over the last few years¹, thereby making DIP credit difficult to obtain. As a result, most Chapter 11

¹ Bank of America, a large player in the retailer DIP financing market, reported their 3rd quarter loan loss reserves this year at \$11.7 billion, as compared with \$1.17 billion in the 3rd quarter of 2006. While this dramatic increase in loan loss reserves was not directly in response to DIP loan losses, it clearly indicates a tougher lending environment for companies who have the enhanced credit risk of being in Chapter 11.

debtors have no alternative but to seek DIP financing from its existing pre-petition secured lenders.

Pre-petition secured lenders are routinely faced with the prospect of having to make advances to its newly filed Chapter 11 borrower that exceed the amounts available under the formulas established pre-petition for advances based on collateral values. These “over-advances” are in most cases not “collateral good” or based on positive cash flow. Consequently, in an effort to reduce the probabilities of further losses, the pre-petition lender will usually make these loans sparingly (i.e., in strict accordance with a budget) in order to bridge to a near-term liquidity event (e.g., liquidation or going concern sales). These DIP facilities are sometimes referred to as “defensive” DIP facilities. The DIP lender in a “defensive” DIP facility is in many cases in the position of having to provide financing arrangements to a “melting ice cube”(i.e. a deteriorating pool of assets) with the mounting costs of Chapter 11 further eroding the secured lenders’ prospects of recovery. The longer the sale process or liquidity event takes to be consummated, the smaller the asset recovery value will be. As such, logic and prudent lending practice dictate that DIP lenders require the company to aggressively pursue the prompt realization of value on the lender’s collateral as a condition to providing DIP financing. In the DIP financing documents, this takes the form of having the Chapter 11 debtor agree to various sale “milestones” or similar asset sale covenants designed to ensure that the collateral will be marketed and sold or otherwise monetized, within the first few months of the Chapter 11. Of course, not all prospective Chapter 11 debtors, upon planning for bankruptcy, are willing to agree to such sale covenants in the proposed DIP financing documents.

Ideally, every prospective Chapter 11 debtor would rather utilize the benefits of Chapter 11 to reorganize as opposed to selling their assets to satisfy the secured lenders’ debt. For

various reasons, however, some debtors resist utilizing Chapter 11 to effect a sale of their assets even when a reorganization is not feasible, and will instead threaten to use the cash collateral of the pre-petition secured lender without consent, or perhaps entertain priming lien financing proposals in order to gain some leverage in negotiating for DIP financing terms that suit their perceived needs, rather than addressing the risks to the lender. However, as is often the case, an over-leveraged business will usually not be able to survive in Chapter 11 on its cash receipts alone, and with the credit freeze still thawing, commercial lenders and private equity groups are not as willing to bridge the liquidity gap of these ailing companies. Without some party, like the government making decisions as in Chrysler or GM to provide funding, the Chapter 11 debtor's management will often have no alternative other than to seek the most effective liquidation or sale process available to maximize the value of the assets. Obviously, if a potential Chapter 11 debtor either has equity in its assets in excess of the pre-petition secured debt or a substantial enterprise value as compared with a liquidation value of its assets, one or more lenders may, on a sound commercial basis, be willing to compete for the right to provide the potential Chapter 11 debtor with an "offensive" or "new money" DIP facility. In such a situation, the DIP financing terms might allow the Chapter 11 debtor greater flexibility, to reflect that there is less risk to the lender.

It is the prospective Chapter 11 debtor's financial condition and business prospects, and not the terms of the DIP credit facility, that determine the likelihood of a successful reorganization. To illustrate this reality, described below are three retail Chapter 11 cases filed within the last several years that had substantially similar DIP financing terms containing substantially all of the typical "pro DIP lender" provisions and were extended by the pre-petition secured lenders to each retail debtor. All three debtor companies entered Chapter 11 with the

intention to reorganize. Two of the three companies wound up as “liquidating 11’s”. The third company successfully reorganized. What made the third company different?

The two “liquidating 11” cases are RCC Liquidating Corp (f/k/a Ritz Camera), Case No. 09-10617 (MFW) (petition filed in Del. Bankr. Ct. on February 2, 2009), a 600 store-chain retail operation selling camera merchandise and boating equipment, and Mervyn’s Holdings, LLC, Case No. 08-11586 (KG) (petition filed Del. Bankr. Ct. on July 29, 2008), a “big box” department store chain on the West Coast. Both debtor companies had substantially similar “defensive” DIP financing terms provided by their respective pre-petition lenders, including a roll-up of the pre-petition debt, 506(c) waiver, automatic stay relief on limited notice, and covenants relating to asset sales, budgetary restrictions, expanded events of default and releases of potential claims against the DIP lenders. Both initially tried to reorganize their respective businesses by conducting “going-out-of business” asset sales at the outset of the Chapter 11 at poorly performing store locations with an eye toward reorganizing around a smaller, leaner core group of store locations. Both companies unsuccessfully tried to obtain alternative financing and/or raise capital to reorganize their respective businesses, and both companies ultimately determined (within 3 months into their respective bankruptcy cases) that an orderly liquidation/sale process of the remaining assets was the only viable solution to maximize the recovery for all estate creditors.

On the other end of the spectrum is the Chapter 11 case of Hancock Fabrics, Inc., Case No. 07-10353 (BLS) (petition filed in Del. Bankr. Ct. on March 21, 2007). Hancock Fabrics is an arts and crafts and sewing accessories retailer with over 100 store locations. The DIP financing terms of Hancock were substantially similar to the DIP financing provided to Ritz Camera and Mervyns. Hancock also pursued the same strategy in its Chapter 11 (i.e.,

immediately liquidate assets at poorly performing stores and attempt to reorganize the business around the remaining, profitable stores). Unlike Mervyn's and Ritz, however, the business prospects and performance of Hancock remained strong during its Chapter 11 case, and the company ultimately reorganized and emerged from Chapter 11 within a year of its filing. If the terms of the so-called over-bearing DIP credit facilities truly deprive Chapter 11 debtors of the ability to reorganize their businesses, then Hancock should not have successfully reorganized its business.

Perhaps the best example of a case in which the Bankruptcy Court truly understood that a “defensive” DIP financing facility is not driven by the DIP lender, but is rather a function of the financial condition of the debtor, is found in the February 2006 decision by the Chief Judge of the Bankruptcy Court for the Southern District of New York in Musicland Holding Corp. (Case No. 06-10064, Docket no. 534). In Musicland, the debtor, an 800 plus retail store chain selling CD's, DVD's and related products, sought approval of a classic “defensive” DIP facility from its pre-petition lenders, in which the lenders required the usual list of defensive DIP financing protections, such as a roll-up of the pre-petition debt, strict compliance with an operating budget with a small degree of permitted variance, debtor's retention of liquidation and financial consultants acceptable to the pre-petition lenders, and compliance with a liquidation covenant that required the debtor to commence “GOB” sales within several months of the commencement of the Chapter 11. The Creditors Committee in Musicland opposed the DIP Facility on various grounds, including that the DIP financing provisions (particularly the liquidation covenant) were so onerous that the debtor “may just as well turn the keys over to the DIP Lenders” (Committee Objection, p. 2, Docket No. 351). Chief Judge Bernstein overruled the Committee's objection in all respects. In doing so, the Judge found that the debtor was hemorrhaging cash and could not

provide adequate protection to the various classes of secured creditors (including a class of junior secured trade creditors that were undersecured by more than \$60 million), and that the DIP loan was the best alternative to allow the debtor to maximize the value of the estate's assets. The Judge also found that the liquidation covenant was imposed on the debtor by "the economic realities of the case", rather than by the DIP lender. Clearly, if the Chapter 11 debtor was not in such poor financial condition, that is had no equity in the assets above the value of the secured claims and had no going concern value that could have made a reorganization an attractive business proposition to finance, the terms of the DIP facility would not have mandated an expeditious sale process of the debtor's assets to maximize asset recovery values.

Rather than regulating the provisions of DIP facilities and DIP financing orders that are designed to reduce the risk of loss by the lender, the focus should be shifted to pre-bankruptcy planning in an effort to assist companies to restructure while it is still feasible. If there is a viable business and a reasonable probability of successfully restructuring, lenders will take advantage of the opportunity and seek to provide financing or provide financing terms that support such a result. The "pre-arranged" (not to be confused with pre-packaged) Chapter 11 filing of Spectrum Jungle Labs Corporation, et al. Case No. 09-50455 (RBK) (Bankr. W.D. Texas) illustrates how a pre-petition lender providing DIP lending with many of the "pro-DIP lender" provisions can nonetheless result in a heavily leveraged debtor achieving a successful reorganization. Companies that fail to address well in advance of the Chapter 11 filing whether they will have sufficient DIP financing to reorganize their businesses will almost always end up in a "liquidating 11." However, if a prospective Chapter 11 debtor instead considers Chapter 11 while it still has equity in its assets or a viable business, the prospective Chapter 11 debtor may

be able to chose between potential DIP lenders and/or may be able to negotiate a more favorable DIP facility from its pre-petition lenders in the absence of alternative financing.

DIP Financing: Too Much Lender Control?

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I. Introduction

Lenders today routinely use debtor-in-possession financing (“DIP financing”) agreements to gain substantial control over debtors in Chapter 11 and the bankruptcy reorganization process. The currently accepted degree of lender control over the Chapter 11 process has evolved into a major de facto change in the bankruptcy process that inhibits the rehabilitation of distressed companies. This evolution has been accelerated by the overleveraging of debtors, the proliferation of secured financing, restrictions on the time for debtors to assume or reject leases, the exorbitant cost of DIP financing and the availability of forms of DIP financing documents on the Internet. Whether this change is bad policy, or merely an economically efficient reallocation capital, is open to debate.

II. Increased Control by DIP Lenders

Even scholars who praise the benefits associated with economically efficient liquidity events (*i.e.*, liquidations or going concern sales) acknowledge that Chapter 11 has changed dramatically, from a paradigm of court-supervised reorganization to a “secured-creditor driven system that results much more often in liquidation.”¹ One manifestation of this sea change in the world of bankruptcy reorganizations is the reality that DIP Financing does not work the way it used to. Today DIP financing is frequently a mechanism by which lenders exert considerably more control over debtors and the bankruptcy reorganization process than ever before.

For example, in the widely discussed case of *Tenney Village*,² the court rejected a proposed DIP financing agreement that contained many of the DIP lender-control provisions that are customarily approved today. In *Tenney* the debtor had financed condominiums and improvements to a ski area that it operated.³ The proposed DIP financing agreement would have given the bank substantial control over the debtor as well as the Chapter 11 process, including the following: 1) bank approval of the specifications for the debtor’s planned improvements; 2)

¹ Testimony of Prof. Todd J. Zywicki before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, 111th Congress, 1st Session for Hearings on “Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?” March 11, 2009 (the “Congressional Testimony of Prof. Todd J. Zywicki”), at 47, accessed on October 28, 2009 at http://judiciary.house.gov/hearings/hear_090311_1.html.

² *In re Tenney Village Co., Inc.*, 104 B.R. 562 (Bankr. D.N.H. 1989).

³ *Id.* at 563.

direct supervision by the bank's consultant of the debtor's work on improvements; 3) the right to require the debtor to hire a new chief executive, subject to approval by the bank; 4) bank approval of the debtor's plan to market condominiums; 5) bank approval of a new marketing firm hired to market the condominiums; 6) specific minimum unit values for sales of condominiums; 7) deposits of all proceeds from condominium sales into a collateral account at the bank, and the right to apply the balance in the collateral account to the outstanding obligation at any time; 8) granting of highest administrative expense priority to the bank's claims; 9) the effect of any "termination event" would be to vacate the automatic stay to permit foreclosure by the bank, where "termination events" include (i) a plan of reorganization being confirmed over the Bank's objection, (ii) a third party obtaining relief from the automatic stay without the Bank's consent, and (iii) any creditor or other party in interest taking any action against the Bank; 10) waiver of the debtor's potential claims and defenses against the Bank, including the right to assert preference, fraudulent transfer and other avoiding powers.⁴ Moreover, the DIP financing agreement in *Tenney* was troubling⁵ because it was a roll-up that granted the bank a mortgage securing the outstanding pre-petition debt (roughly \$16,600,000) *and* the post-petition debt (\$1,000,000 in new money).⁶ Further, the entire debt was to become due approximately 5 months after the date of the DIP financing agreement.⁷

The bankruptcy court found the lender's degree of control "shocking."⁸ In rejecting the DIP financing agreement, the court concluded:

"The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the [b]ank and the [d]ebtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code. Under its rights of approval and supervision, the Bank would in

⁴ *Tenney* at 567.

⁵ See *In re Dynaco Corp.*, 162 B.R. 389, 397 (Bankr. D.N.H. 1993), acknowledging "the egregious overreaching by the proposed new financing party [in *Tenney*], including the proposed inappropriate granting of new security for that party's own prepetition unsecured claims."

⁶ *Tenney* at 563.

⁷ *Id.* at 567.

⁸ *Id.* at 568.

effect operate the Debtor's business. The Code permits this to be done only by a debtor or trustee.”⁹

The court went on to enumerate the ways in which the contemplated lender control violates various provisions of the Bankruptcy Code.

Tenney was decided in 1989. Yet, today, DIP financing credit agreements frequently contain provisions analogous to those rejected by the *Tenney* court. For example, in *Yellowstone*,¹⁰ the debtor operated an exclusive, membership-based ski resort. The court approved a DIP loan (at 15% interest) that gave the DIP lender significant control over the bankruptcy process via “restructuring benchmarks” which specified the dates by which the debtor was required to collect membership dues, file a Chapter 11 plan, and have the plan confirmed.¹¹ If the benchmarks were not met, the debtor agreed to immediately commence a Section 363 sale of substantially all its assets.¹² Likewise, in *Lyondell*,¹³ the DIP lenders extended a roll-up loan for \$8 billion. The DIP financing agreement gave DIP lenders substantial control over the Chapter 11 process, including drop-dead dates for delivering a draft plan of reorganization within 7 months, filing the plan within 8 months, and confirming the plan within 11 months. The cost of interest plus fees was 20%. Similarly, in *Reader’s Digest*,¹⁴ the DIP lenders were among the senior prepetition lenders who were owed \$1.6 billion. The DIP lenders provided \$150 million in new money, at an aggregate rate of at least 14.5% interest (based on a LIBOR floor), and thereby obtained significant control of the reorganization process, to the extent that they required the debtor to file a Chapter 11 plan of reorganization within 75 days and have it approved within 195 days (with the possibility of a 3-month extension if conditions in the loan agreement were met).¹⁵ Further, in *Propex*,¹⁶ the initial DIP loan expired,

⁹ *Id.* at 568.

¹⁰ *In re Yellowstone Mountain Club, L.L.C.*, Case No. 08-61570-112008, Bankr. LEXIS 4062 (Bankr. D. Mont. Dec. 17, 2008).

¹¹ *Id.* at 19-20.

¹² *Id.* at 20.

¹³ *In re Lyondell Chemical Co.*, Case No. 09-10023 (Bankr. S.D.N.Y. Jan. 11, 2009); Gregory G. Hesse and Kent J. Laber, *DIP Financing: Where is the Liquidity to Reorganize and What Will it Cost You?*, 27th Annual Advanced Business Bankruptcy Course, October 1-2, 2009, at 18.

¹⁴ *In re The Reader’s Digest Association, Inc.*, Case No. 09-23529 (Bankr S.D.N.Y. Aug. 24, 2009).

¹⁵ *Debtor’s Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to Obtain Postpetition Financing and Letters of Credit, and to Use Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Lenders, (III) Scheduling a Final Hearing, and (IV) Granting Related Relief*, (the “DIP Financing Motion”), [DOCKET No. 13] (Aug. 24, 2009) at 5-11; *see also* Hesse and Laber, at 17.

¹⁶ *In re Fabrics Estate Inc.*, Case No. 08-10249 (Bankr. E.D. Tenn. 2008); *see also* Hesse and Laber, at 21.

and the initial DIP lenders refused to extend the maturity date and provide exit financing.¹⁷ The subsequent DIP lender (also a prepetition secured lender) used the DIP financing agreement to become the stalking horse bidder. Moreover, the agreement included a provision granting the DIP lender the right to approve bid procedures.¹⁸ Consequently, the DIP lender was able to purchase the company, while earning \$3 million in fees for a \$65 million DIP and exit facility with an interest rate of LIBOR plus 10%.¹⁹ Finally, in the *Square Mile Energy* case in Houston the effective rate of the DIP loan was 8% **per month** (*i.e.*, 96% annually).

While each of the foregoing cases is merely illustrative, the trend toward using DIP financing as a mechanism to gain control over the bankruptcy process is clear. DIP lenders have successfully taken on many of the control functions of operating the debtor, which formerly were the province of the debtor-in-possession. These functions include supervising the implementation of capital improvements, setting prices for the sale of debtor assets, requiring the debtor to hire a new CEO or CRO subject to the DIP lender's approval, and requiring the debtor to replace existing service providers, such as marketing companies, with lender-approved service providers.

Likewise, DIP lenders have taken on many of the functions that used to be the sole bailiwick of the bankruptcy court, including setting the timeline for filing a plan and requiring a plan to be confirmed, setting timetables for the disposition of specific assets, requiring DIP lender approval of auction procedures in connection with a liquidation or going concern sale, and requiring the debtor to waive the estate's preference claims, fraudulent transfer claims, and avoidance powers.

III. Do DIP Lenders Exert Too Much Control Over the Bankruptcy Process?

There is concern among bankruptcy practitioners and scholars that Chapter 11 no longer serves the objective of reorganizing businesses in order to preserve jobs, benefit the communities in which businesses are located, and thereby serve our national interest in having a vibrant

¹⁷ Hesse and Laber, at 21.

¹⁸ *Id.* at 21.

¹⁹ Hesse and Laber, at 21.

economy.²⁰ Chapter 11 was designed to be a tool to address the problem of distressed businesses that are the natural result of excess credit in our credit-intensive world.²¹ The purpose of Chapter 11 is to rehabilitate such businesses by balancing the needs of debtors with the rights of creditors and the interests of business owners.²² The degree of control currently wielded by DIP lenders arguably upsets this balance.

From a larger policy perspective, we might regard businesses as more than the sum of their financial, human and physical capital. Successful businesses take years to build, they involve relationships that have been developed over time as the result of effort and integrity, and they involve communities that rely on the lifeblood of employment to foster civic engagement and political participation. Successful businesses are one of the fundamental building blocks of our democracy. Therefore we should be concerned by legal roadblocks and market practices that hinder the rehabilitation of distressed companies, particularly those companies whose capital structures require reorganization when the excess credit in the capital markets dries up. When a company fails, the relationships on which it was built are destroyed, the communities in which it is located suffer, and our civic life is diminished. The awareness that the values our society holds dear are not fully recognized on a balance sheet, coupled with the knowledge that it is always easier to destroy than it is to create, counsel against the cavalier destruction of distressed businesses.

Furthermore, the concern that secured lenders should get what they bargained for, even in bankruptcy, may be overblown. After all, lenders take risks, one of which is the risk of reduced payment or nonpayment. When such risks manifest themselves, and thereby increase the costs of credit to more accurately account for such risks, the result is to reduce the excess credit in the market that otherwise leads to unsustainable bubbles. Thus the risk of delayed or reduced payment in bankruptcy could operate as a damper that moderates the otherwise devastating effects of the boom and bust cycle. Perhaps the resulting increase in cost of capital would lead to

²⁰ Testimony of Harvey R. Miller before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, 111th Congress, 1st Session for Hearings on “Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?” March 11, 2009 (the “Congressional Testimony of Harvey R. Miller”), at 12, accessed on October 28, 2009 at http://judiciary.house.gov/hearings/hear_090311_1.html.

²¹ *Id.* at 12-13..

²² Congressional Testimony of Harvey R. Miller at 13.

more prudent, long term financial planning, and less focus on short term profits and unsustainable levels of leverage. This might be wise policy.

IV. What Legislative Changes Might Be Effective?

Courts are often presented with a Hobson's choice: approve the DIP loan on the terms dictated by the lenders; or call the lenders' bluff²³ and thereby risk imminent liquidation of the debtor. In addition, even though a given court may decline to approve DIP financings containing objectionable terms, other courts may be more sympathetic to the demands of the lenders. The result will be forum shopping and non-uniform application of the law in Chapter 11 cases. Therefore it is likely that only legislative changes will effectively change the DIP lending landscape.

One legislative policy prescription would be to disallow treatment of rolled-up debt as an administrative claim. Specifically, lenders would only be allowed to treat "new money" as an administrative claim, not prepetition obligations. This would be analogous to the treatment of cash collateral under cases such as *In re 360 Inns*, where the court found that "continuing use of [debtor] revenues should not be construed as post-petition advances of credit in the same context as if new monies were being poured into the debtor by [the pre-petition lender]."²⁴ For example, if a lender (or a syndicate of lenders) were owed \$10 million in prepetition debt, and rolled that debt into an \$11 million "defensive DIP" financing agreement while providing only \$1 million of new money, then the DIP lender would only be allowed an administrative claim to the extent of the new money it contributed to the estate. Hence the prepetition lender would be left with a \$1 million administrative claim, and a \$10 million pre-petition claim. If the prepetition loan of the lender is either unsecured or under collateralized then interest would only accrue on the new money and the lender would not be entitled to reimbursement for attorneys fees and other costs attributable to the prepetition loan.²⁵ An amendment to the Bankruptcy Code that embodies this concept could be applied straightforwardly without unduly disrupting commercial lending practices.

²³ In the *Zale, Inc.* Chapter 11 case the court refused to approve the initial DIP proposal and the lenders renegotiated the DIP loan to alleviate the concerns of the court.

²⁴ *In re 360 Inns, Ltd.*, 76 B.R. 573, 578 (Bankr N.D.Tex. 1987).

²⁵ See Section 506 of the Bankruptcy Code.

Other policy changes that would return control and discretion to the bankruptcy courts would be to prohibit a DIP lender from dictating the timing of asset sales, auction procedures or the form or timing of the plan of reorganization. Similarly, the Bankruptcy Code could be amended to prohibit waiver of the estate's preference claims, fraudulent transfer claims, and avoidance powers as part of the DIP lending process.

Lenders assert that such provisions will restrict the availability of DIP financing and result in more liquidations, fewer reorganizations and lower returns to creditors. The counterargument to that is that there is no demonstrable connection between restrictions on DIP financing and the availability or cost of DIP financing. Further, the enormous charges recently extracted by DIP lenders is indicative of a contract of adhesion encouraged by the perceived unwillingness of courts to decline to approve oppressive DIP facilities when it is clear that for the lenders to maximize their recovery the enterprise value of the debtor must be preserved. While a theoretical economic perspective assumes that the provision of DIP credit follows classic rational economic principles, in reality the actions of "defensive DIP" lenders are often predicated on the parochial interests of the diverse members of the lending syndicate.

The Bankruptcy Code was predicated on the "George Bailey"²⁶ model of a lender who makes a loan with the intent of some day collecting on that loan. This model no longer accurately describes market practices. Instead, in today's lending market the agent for a syndicate of lenders arranges a loan for a significant fee, often millions of dollars. The agent may keep a small portion of the credit but will "syndicate" the loan to several, or as many as hundreds, of members of the syndicate, each of whom purchases small slices of the loan. These slices are then traded back and forth in the market. The syndicate members are often funds who never intend to collect on the loans. To further complicate the situation, the owners of the slices often enter into derivative contracts such as credit default swaps to hedge their positions or purchase debt or equity of the borrower at different levels of the corporate group structure of the debtor. Consequently, the motivations of the members of the lending syndicate range from the classic model of the lender who wants to maximize the collection possibilities of the loan by the successful reorganization of the debtor, to the syndicate member who has purchased a slice of the

²⁶ See Frank Capra, *It's A Wonderful Life* which is shown many times each Christmas season.

credit at a deep discount and wants to liquidate the collateral as quickly as possible, to the institutional lender who simply wants to avoid a write off of its slice of the loan this quarter, to the hedge fund owner of a slice who has shorted other securities of the debtor or who holds credit default swaps and would therefore profit from the debtors' demise. The DIP loan may be utilized for any of these purposes, or as the first step in a "loan to own" strategy.

Congress must first recognize the marketplace reality of these competing interests, and then balance the positive aspects of debtor reorganization against the legitimate needs and rights of lenders, while discarding the rhetoric of those who believe that every business should be reorganized as well as the myth that the availability of DIP financing and its pricing are functions of rational measures of risk.

Lenders also suggest that instead of implementing legislative changes that would decrease DIP lender control, the solution is to focus on pre-bankruptcy planning so that distressed companies will file Chapter 11 petitions earlier. Some believe that the problem with this proposed solution is that the decision-makers who decide whether to file a Chapter 11 do not have an incentive to file early, and in fact have every incentive not to file.²⁷ For closely held corporations, the negative incentives are particularly acute, because the managers are typically also the shareholders and the guarantors of the company's debt.²⁸ If the company files for Chapter 11 protection, these owner-managers will likely see their equity wiped out under the absolute priority rule²⁹ and they will ultimately be personally liable for payment of their guaranties. Even in large public corporations, the incentives are askew, because executives will likely lose their jobs,³⁰ the value of their stock and their stock options, if they decide to file a Chapter 11 petition. The net result of such incentives is that the opportunity for creditors and equity holders to realize the going concern value from a carefully planned successful

²⁷ Richard E. Mikels and Peter S. Kaufman, *Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 For Mutual Benefit*, 22-10 ABI Journal 26 (December 2003/January 2004), accessed on November 3, 2009 at <http://www.abiworld.org/AM/Template.cfm?Section=Home&Template=/MembersOnly.cfm&ContentID=35077&FusePreview=False>.

²⁸ *Id.*, at 5.

²⁹ 11 U.S.C. §§ 1129(b)(2)(B)(i) and (ii).

³⁰ Testimony of Prof. Barry E. Adler before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, 110th Congress, 2nd Session for Hearings on "Lehman Brothers, Sharper Image, Bannigan's and Beyond: Is Chapter 11 Bankruptcy Working?" September 26, 2008 (the "Congressional Testimony of Prof. Barry E. Adler"), at 20 (citing K. M. Ayotte and E. R. Morrison, *Creditor Control and Conflict in Chapter 11*, 2nd Annual Conference on Empirical Legal Studies (2007)).

reorganization is often lost.³¹ Because the incentives of decision-makers are misaligned, rational decision-makers operating in their individual best interests at each step of the process contribute to an aggregate systemic result that is sub-optimal.

It has also been suggested that the 120-day limit on exclusivity, which may be extended to a maximum of 18 months upon approval of the court,³² and the application of the absolute priority rule³³, which often eliminates the equity interests in a Chapter 11 case, act as a disincentive to earlier filing by debtors.³⁴ But the restrictions on exclusivity may not significantly alter the timing of Chapter 11 filings or the contents of DIP financing agreements, because DIP financing agreements would likely continue to include provisions setting dates by which reorganization plans must be submitted and confirmed or requiring the sale of assets of the debtor by dates certain long before the expiration of the exclusivity period. Creditors will contend that elimination of the absolute priority rule will inequitably alter the negotiating balance away from creditors and may result in tighter DIP restrictions by lenders to protect their interests.

v. **Is The Degree of DIP Lender Control in Bankruptcy Appropriate?**

On one hand, many scholars and practitioners have expressed concern that DIP financing is not working effectively, and is thereby contributing to the difficulty of successfully reorganizing debtors in Chapter 11. On the other hand, some argue that nothing should be done to change the Bankruptcy Code provisions relating to DIP financing. The existing degree of DIP lender control over the bankruptcy process may not be bad policy, but rather part of an imperfect yet relatively efficient market that channels human, physical and financial capital towards its most productive uses. Under this view, the system is working as well as can be expected, given the sudden collapse of the credit markets and much of the financial sector. After all, “[b]ankruptcy is uniquely Darwinian”³⁵ in that it adapts to current economic conditions, and it

³¹ Mikels and Kaufman, at 2.

³² 11 U.S.C. §§ 1121(b) and (c).

³³ 11 U.S.C. §§ 1129(b)(2)(B)(i) and (ii).

³⁴ See Mikels and Kaufman, *supra*.

³⁵ Miller, Matt, *From Liquidity to Liquidation*, The Deal Magazine, September 11, 2009, accessed at <http://www.thedeal.com/newsweekly/features/from-liquidity-to-liquidation.php> on October 27, 2009.

may be wise to attribute the current rise in liquidations of Chapter 11 debtors to market-driven phenomena rather than de facto legal changes and creditor dominance in the bankruptcy process.

In the past, when the bankruptcy process more aggressively allowed debtors to confirm reorganization plans, distressed companies routinely emerged from bankruptcy regardless of whether they had cured the operating problems that brought the firm into bankruptcy in the first place.³⁶ Thus it should not be surprising that nearly a third of the large, publicly traded firms that reorganized in the United States from 1991 to 1996 went out of business within five years.³⁷ Likewise, more than 40% of firms that reorganized in Delaware and 20% of firms that reorganized in the Southern District of New York filed for bankruptcy protection a second time within five years.³⁸ In addition, the managers who oversaw the descent of a company into bankruptcy frequently remained in control of the debtor during bankruptcy, and sometimes after.³⁹

In contrast, in the new era of creditor dominance in Chapter 11, when a company files for bankruptcy a secured creditor typically quickly wrests control of the case from the debtor's managers.⁴⁰ The DIP loan is often the vehicle for such control, because the DIP lender provides crucial financing with strings attached, such as vesting the lender with management prerogatives.⁴¹ Consequently top managers now lose their jobs almost three-quarters of the time⁴² and the bankruptcy process is commonly converted from a protracted negotiation to an efficient liquidation.⁴³

Without denying the costs that liquidation imposes on suppliers, employees, and local communities, one must remember that a new financial structure will not rehabilitate a business

³⁶ Congressional Testimony of Prof. Barry E. Adler, at 20-21.

³⁷ *Id.* at N. 1 (citing L. LoPucki and Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 *Vanderbilt L. Rev.* 1933 (2002)).

³⁸ *Id.*

³⁹ *Id.* at 20.

⁴⁰ *Id.* (citing D. G. Baird and R. K. Rasmussen, *Chapter 11 at Twilight*, 56 *Stanford L. Rev.* 673-699 (2003) and D.A. Skeel, *Creditors' Ball: The 'New' New Corporate Governance in Chapter 11*, 152 *Penn. L. Rev.* 917-951 (2003)).

⁴¹ *Id.*

⁴² *Id.* (citing K. M. Ayotte and E. R. Morrison, *Creditor Control and Conflict in Chapter 11*, 2nd Annual Conference on Empirical Legal Studies (2007)).

⁴³ *Id.* at 21.

that is not economically viable.⁴⁴ Firms do not enter bankruptcy randomly.⁴⁵ Many, perhaps most, fail for the old-fashioned reason: a poor business plan poorly executed.⁴⁶ Chapter 11 cannot help a company that offers an expensive product that customers do not want.⁴⁷ Worse, if a futile reorganization attempt delays the inevitable and consumes resources the creditors could otherwise reinvest, society is not well served.⁴⁸

Moreover, cases like *First Magnus*⁴⁹ show that bankruptcy courts continue to scrutinize DIP financing agreements in light of the facts, circumstances and economic context, and use their discretion to reject lender overreach where appropriate. In *First Magnus*, a case that was filed before the collapse of Lehman Brothers and the onset of the recent economic downturn, the DIP lender agreed to provide a \$15 million credit facility in exchange for 18.25% interest (prime rate plus 10%), a closing fee of 7% (\$1,050,000), a \$75,000 due diligence fee, and a \$5,000 monthly audit fee, as well as a super priority lien over all administrative expense claims and unsecured claims, a first priority security interest in all debtor's assets and proceeds,⁵⁰ and a provision stating that interested parties could not object to approval of the DIP financing facility based on the adequate protection provided for in the agreement.⁵¹

The court denied the DIP financing facility because of overreaching by the DIP lender, the potential adverse impact on prepetition secured creditors, and the "overly expensive credit."⁵² The court calculated the effective cost of the loan, after fees and interest, as \$3,922,500, or

⁴⁴ *Id.* at 22.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *In re First Magnus Financial Corporation*, Case No. 4-07-bk-01578 (Bankr. D. Ariz. August 21, 2007).

⁵⁰ *Emergency Motion of First Magnus Financial Corporation for an Interim Order (A) Authorizing first Magnus Financial Corporation to Obtain Postpetition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362 and 364; (B) to Utilize Alleged Cash Collateral Pursuant to 11 U.S.C. § 363; (C) Deeming Prepetition Secured Parties Adequately Protected Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364; and (D) to Schedule a Final Hearing Pursuant to Bankruptcy Rules 4001(b) and Local rule 4001-4* (the "DIP Financing Motion") [Docket No. 79], dated August 31, 2007, at 16-17; *see also* Holland N. O'Neil, Thomas E. Patterson and Michael D. Warner, *Current Developments in DIP Financing, Absolute Priority, and Pre-Confirmation 363 Sales*, 2009 Southwest Bankruptcy Conference, American Bankruptcy Institute, Sept. 10-12, 2009, at 513-515.

⁵¹ DIP Financing Motion at 20.

⁵² *Order Denying Debtor's Request to Borrow up to \$15,000,000 for Purposes of Keeping Operational* (the "DIP Financing Order") [Docket No. 137], dated September 7, 2007, at 1.

26.15% of the loan.⁵³ Thus some courts are still willing to reject proposed DIP financing where DIP lenders seek levels of control and financial terms that appear unreasonable under the facts and circumstances of the case. However, as discussed *supra*, although a bankruptcy court may reject a particular DIP financing proposal in a given case, the result will likely be forum shopping rather than systemic changes that reduce lender control.

Conversely, cases such as *General Growth Properties*⁵⁴ show that when a group of debtors has significant cash flow and valuable assets, it can obtain a workable DIP loan, even in these times of tight credit. In *General Growth Properties*, a syndicate of DIP lenders extended a \$400 million, twenty-four month loan, which included a provision giving the debtor 210 days to bring avoidance actions.⁵⁵ Roughly \$215 million of this loan was designated to pay a different prepetition lender, and the estate received approximately \$185 million in new money.⁵⁶ Although the DIP lender exercised some control in *General Growth Properties*, such control does not appear to materially impede the debtor's prospects for reorganization, and is less invasive than other cases discussed above. The lesson here is that more reasonable DIP financing is available when a debtor seeks bankruptcy protection in a timely fashion rather than waiting until it has no other source of operating funds.

Lenders legitimately contend that if the lender is undercollateralized, then the lender has all of the downside of the reorganization process and should be able to maintain a high degree of control over the operations of the debtor during the Chapter 11 case. They also contend that increased risk to lenders will result in higher credit cost and limited availability DIP credit to debtors. These considerations must be balanced with the overall objective of reorganization.

A key function of Chapter 11 is to distinguish between firms that are economically failed and those that are merely in financial distress.⁵⁷ Indeed, when an economically failed company

⁵³ *Id.*

⁵⁴ *In re General Growth Properties, et al.*, Case No. 09-11977 (ALG) (Bankr. S.D.N.Y. April 16, 2009).

⁵⁵ *Final Order Authorizing Debtors to (A) Obtain Postpetition Secured Financing Pursuant to Bankruptcy Code Section 105(a), 362 and 364, (B) Use Cash Collateral and Grant Adequate Protection Pursuant to Bankruptcy Code Sections 361 and 363 and (C) Repay In Full Amounts Owed Under Certain Prepetition Secured Loan Agreements (the "DIP Order")* [Docket No. 527], dated May 14, 2009, at 11-12; *see also* O'Neil, Patterson and Warner, at 523.

⁵⁶ DIP Order at 7.

⁵⁷ Congressional Testimony of Prof. Todd J. Zywicki at 47.

liquidates shortly after entering Chapter 11, the decisive resolution of the company's prospects clears the way for more vibrant competitors to grow, and reallocates the financial, human and physical capital of the enterprise.⁵⁸ On the other hand, the premature liquidation of a viable business, without providing the opportunities that Chapter 11 was designed to afford, has serious negative consequences. Therefore, appropriate legislative changes should be explored to meet the legitimate requirements of lenders, suppliers, landlords, the credit markets, employees, other creditors, communities, and the broader economy.

⁵⁸ Congressional Testimony of Prof. Todd J. Zywicki at 47.

