

# THE USE OF DIP FINANCING AS A MECHANISM TO CONTROL THE CORPORATE RESTRUCTURING PROCESS<sup>1</sup>

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- I. INTRODUCTION..... 16
  - A. The Trend Toward Increasing DIP Lender Control Over the Bankruptcy Process..... 16
- II. THE ARGUMENT THAT CURRENT LEVELS OF DIP LENDER CONTROL ARE EXCESSIVE..... 20
- III. LEGISLATIVE SOLUTIONS ..... 21
- IV. THE ARGUMENT AGAINST REDUCING DIP LENDER CONTROL ..... 24

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## I. INTRODUCTION

Lenders routinely use debtor-in-possession (“DIP”) financing agreements to gain substantial control over debtors in Chapter 11 and the bankruptcy reorganization process. However, 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 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 of capital, is an issue that courts, scholars, and practitioners are struggling to address.

### A. The Trend Toward Increasing DIP Lender Control Over the Bankruptcy Process

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.”<sup>2</sup> 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.

The widely discussed case of *Tenney Village*<sup>3</sup> illustrates this point. In *Tenney*, the court rejected a proposed DIP financing agreement that contained many of the DIP lender-control provisions that are customarily approved today. The *Tenney* debtor had financed condominiums and improvements at a ski area that it operated.<sup>4</sup> The proposed DIP financing agreement would have given the bank substantial control over the debtor as well as the Chapter

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<sup>2</sup> *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs: Hearing Before the H. Subcommittee on Commercial and Administrative Law*, 111th Cong. 45-53 (2009) [hereinafter *Circuit City*] (Statement of Todd J. Zywicki, Prof., George Mason University School of Law).

<sup>3</sup> *In re Tenney Vill. Co., Inc.*, 104 B.R. 562, 563 (Bankr. D.N.H. 1989).

<sup>4</sup> *Id.* at 563.

11 process, including: (1) bank approval of the specifications for the debtor's planned improvements; (2) 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 the 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 the highest administrative expense priority to the bank's claims; (9) vacating the automatic stay to permit foreclosure by the bank if any "termination event" occurred, such as (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; and (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.<sup>5</sup> Moreover, the DIP financing agreement in *Tenney* was troubling<sup>6</sup> because it was a roll-up that granted the bank a mortgage securing the outstanding prepetition debt (roughly \$16,600,000) and the post-petition debt (\$1,000,000 in new money).<sup>7</sup> Further, the term of the loan was short. The entire debt was due roughly five months after the date of the DIP financing agreement.<sup>8</sup>

The bankruptcy court found the lender's degree of control "shocking."<sup>9</sup> 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 Bank and the Debtor'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 effect operate the Debtor's business. The Code permits this to be done only by a debtor or trustee."<sup>10</sup>

The court went on to enumerate the ways in which the contemplated lender control violated numerous Bankruptcy Code provisions.

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<sup>5</sup> *Id.* at 567.

<sup>6</sup> *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."

<sup>7</sup> *See Tenney*, 104 B.R. at 563.

<sup>8</sup> *Id.* at 567.

<sup>9</sup> *Id.* at 568.

<sup>10</sup> *Id.*

*Tenney* was decided in 1989; yet, today, *Tenney*-style DIP financing agreements are commonplace. For example, in *Yellowstone*,<sup>11</sup> 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.<sup>12</sup> If the benchmarks were not met, the debtor agreed to immediately commence a Section 363 sale of substantially all its assets.<sup>13</sup> Likewise, in *Lyondell*,<sup>14</sup> 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 seven months, filing the plan within eight months, and confirming the plan within eleven months. The cost of interest plus fees was 20%. Similarly, in *Reader’s Digest*,<sup>15</sup> 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). The DIP lenders 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 three-month extension if conditions in the loan agreement were met).<sup>16</sup> Further, in *Propex*,<sup>17</sup> the initial DIP loan expired and the initial DIP lenders refused to extend the maturity date and provide exit financing.<sup>18</sup> The subsequent DIP lender (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.<sup>19</sup> 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%.<sup>20</sup> Finally, in the *Square Mile Energy* case, out of Houston, Texas, the effective rate of the DIP loan was 8% *per month* (i.e., 96% annual interest).

Thus, there is a marked trend toward lenders seeking to dominate the Chapter 11

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<sup>11</sup> *In re Yellowstone Mt. Club, LLC*, No. 08-61570-11, 2008 WL 5875547 (Bankr. D. Mont. Dec. 17, 2008).

<sup>12</sup> *Id.* at \*6.

<sup>13</sup> *Id.* at \*6-7.

<sup>14</sup> *In re Lyondell Chem. Co.*, 402 B.R. 571, 576 (Bankr. S.D.N.Y. 2009); Hesse, Kent, *DIP Financing: Where is the Liquidity to Reorganize and What Will it Cost You*, 27th Annual Advanced Business Bankruptcy Course, Oct. 1-2, 2009, p. 18-21.

<sup>15</sup> *In re Reader’s Digest Assoc., Inc.*, (Case No. 09-23529 (RDD)) (Bankr. S.D.N.Y. 2009).

<sup>16</sup> “The DIP Financing Motion,” *In re Reader’s Digest Assoc.*, p. 5-11 (Bankr. S.D.N.Y. August 24, 2009); *see also* Hesse, *supra* note 14, at 17.

<sup>17</sup> *In re Propex Inc.*, 415 B.R. 321, 323 (Bankr. E.D. Tenn. 2009); *See also* Hesse, *supra* note 14, at 21.

<sup>18</sup> Hesse, *supra* note 14, at 21.

<sup>19</sup> *Id.* at 21.

<sup>20</sup> *Id.*

process and environment at the onset of cases by way of the DIP order.<sup>21</sup> Further examples of this trend include *In re Gemini Cargo Logistics, Inc.*, where: the debtor filed on June 18, 2008; the court was required to approve auction procedures by June 27, 2008; the debtor was required to enter into a sale of substantially all its assets by August 8, 2008; and the court was required to approve the sale by August 13, 2008.<sup>22</sup> These requirements were enumerated as conditions that, if not met, would terminate the DIP facility. The DIP lender's credit bid was the only qualified, and thus winning, bid.<sup>23</sup> Therefore, the result was equivalent to a foreclosure sale or retention of collateral in satisfaction of the obligation. Similarly, in *In re Whitehall Jewelers Holdings, Inc.*, the debtor filed on June 23, 2008, and the court was required, by the terms of the DIP facility, to approve bidding procedures by July 10, 2008 and to approve a sale by August 4, 2008.<sup>24</sup> Upon notice of an event of default all proceeds of the collateral would go to the DIP lender and the debtor would not have the right to use such proceeds or any other cash collateral. Likewise, in *In re Tronox Inc.*, the DIP credit agreement required sale of the debtor within six months of closing.<sup>25</sup> The equity committee in the case alleged that the decision to sell was a result of DIP lender demands, rather than independent judgment of the debtor, and the equity committee and the unsecured creditors alleged that the DIP lender was requiring a "fire sale."<sup>26</sup> Finally, in *In re Foamex International, Inc.*, the DIP lender not only provided for sale milestones that established a timeline for sale of the debtor, but the DIP facility also contained a provision requiring a \$1.8 million fee if the facility was prepaid.<sup>27</sup> The DIP lender proceeded to acquire the debtor via a credit bid.<sup>28</sup>

While each of the foregoing cases is merely illustrative, the ever-increasing use of DIP financing as a lever to gain control of the bankruptcy process explains how DIP lenders have taken control of many aspects of operating the debtor that used to be within the province of the debtor-in-possession. These operational 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.

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<sup>21</sup> Melanie L. Cyganowski, John C. Wright, & Pauline Yedreyeski, "Chapter 11: Liquidating Cases & Asset Disposition – the Bankruptcy Sale Process," Materials prepared for the 14<sup>th</sup> Annual Bankruptcy Conference of The Capital Region Bankruptcy Bar Association & The Central New York Bar Association, Saratoga Springs, NY, November 7, 2009, at 2.

<sup>22</sup> *In re Gemini Cargo Logistics, Inc.*, 08-18173 (AJC) (Bankr. S.D.Fla. June 20, 2008).

<sup>23</sup> See *supra*, note 22.

<sup>24</sup> Cyganowski, *supra* note 21, at 4; *In re Whitehall Jewelers Holdings, Inc.*, No. 08-11261 (KG), 2008 WL 2951974 (Bankr. D. Del. July 28, 2008).

<sup>25</sup> Cyganowski, *supra* note 21, at 4-5; *In re Tronox Inc.*, 429 B.R. 73, 81 (Bankr. S.D.N.Y. 2010).

<sup>26</sup> *Tronox*, 429 B.R. at 81.

<sup>27</sup> Cyganowski, *supra* note 21, at 11-12; *In re Foamex Int'l Inc.*, 382 B.R. 867, 870 (D. Del. 2008).

<sup>28</sup> *Foamex*, 382 B.R. at 870.

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.

## II. THE ARGUMENT THAT CURRENT LEVELS OF DIP LENDER CONTROL ARE EXCESSIVE

There is concern among bankruptcy practitioners and scholars that Chapter 11 no longer serves the objective of reorganizing businesses to preserve jobs, benefit the communities in which they are located, and thereby serve the national interest in having a vibrant economy.<sup>29</sup> Chapter 11 was designed to be a tool to reorganize the capital structures of distressed businesses that are the natural result of excess credit in this credit-intensive world.<sup>30</sup> The purpose of Chapter 11 is to rehabilitate such businesses by balancing the needs of debtors, the rights of creditors, and the interests of business owners.<sup>31</sup> The degree of control currently wielded by DIP lenders arguably upsets this balance.

From a policy perspective, businesses may be regarded as more than the sum of their financial, human, and physical capital. It takes years for a successful business to build and sustain relationships, as it takes a great amount of time and effort to develop integrity. Businesses are integral to the vibrancy of communities that rely on the lifeblood of employment to foster civic engagement and political participation. Hence, successful businesses are one of the fundamental building blocks of our democracy. It follows that we should be concerned with 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 civic life is diminished. An awareness that the values that 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, counsels against the cavalier destruction of distressed businesses.

From this perspective, 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

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<sup>29</sup> *Circuit City*, *supra* note 2, at 10-25 (Statement of Harvey R. Miller, Weil, Gotshal & Manges, LLP).

<sup>30</sup> *Id.* at 12-13.

<sup>31</sup> *Id.* at 13.

to reduce the excess credit in the market that otherwise leads to unsustainable bubbles. Thus, the risk of delayed or reduced payment in bankruptcy can operate as a damper that moderates the otherwise devastating effects of the boom and bust cycle. Moreover, accepting the reality of such risks should lead to a more sensible, long-term view based on financial institutions holding performing loans rather than initiating and selling loans. Likewise, the resulting increase in cost of capital should lead to more prudent, long-term financial planning by borrowers. Both lenders and borrowers would ultimately benefit from focusing less on short-term profits and avoiding unsustainable levels of leverage. For these reasons, it may be wise policy to maintain bankruptcy laws and foster restructuring practices that force lenders to accept a sizeable portion of the responsibility when the risk of insolvency manifests.

### III. LEGISLATIVE SOLUTIONS

Courts are often presented with a Hobson's choice: approve the DIP loan on the terms dictated by the lenders, or call the lender's bluff and risk imminent liquidation of the debtor. In addition, even though a given court may decline to approve DIP financing arrangements containing objectionable terms, other courts may be more sympathetic to the demands of the lenders. The result is forum shopping and non-uniform application of Chapter 11 law. Accordingly, 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. Under this rule, lenders would only be allowed to treat "new money" as an administrative claim, not prepetition obligations. This solution is 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 prepetition lender]."<sup>32</sup> For example, if a prepetition lender 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 for the new money contributed to the estate. Hence, the prepetition lender would be left with a \$1 million administrative claim and a \$10 million prepetition claim. Further, if the prepetition loan 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 attorney's fees and other costs attributable to the prepetition loan.<sup>33</sup> An amendment to the Bankruptcy Code that embodies this concept could be applied straightforwardly without unduly disrupting commercial lending practices.

Other policy changes that would reduce lender control of the restructuring process,

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<sup>32</sup> *In re 360 Inns, Ltd.*, 76 B.R. 573, 578 (Bankr. N.D.Tex. 1987).

<sup>33</sup> See 11 U.S.C.A. § 506 (West 2011).

while restoring control and discretion to the bankruptcy courts, would be to prohibit a DIP lender from dictating auction procedures, the form of a plan of reorganization, the timing of asset sales, and the timing of the plan of reorganization. The concept that creditors should not be allowed to derail the confirmation of a plan and gain control of the debtor under all circumstances is already enshrined in the “good faith” requirement of Section 1126(e) and the *Alleghany* doctrine.<sup>34</sup> A similar version of this concept could be applied to prevent DIP lenders from requiring the timing and form of a Chapter 11 plan to be subject to their approval. Likewise, the Bankruptcy Code could be amended to prohibit waiver of the estate’s preference claims, fraudulent transfer claims, and avoidance powers against DIP lenders.

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”<sup>35</sup> 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. These funds often enter into derivative contracts, such as credit default swaps to hedge their positions. They also frequently purchase debt or equity at different levels of the capital structure of the debtor. Consequently, the motives of syndicate members 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 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

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<sup>34</sup> See *In re DBSD N. Am, Inc.*, 421 B.R. 133, 138-140 (Bankr. S.D.N.Y. 2009) (citing *In re Allegheny Int’l, Inc.*, 118 B.R. 282 (Bankr. W.D.Pa 1990)).

<sup>35</sup> See *IT’S A WONDERFUL LIFE*. (RKO-Pathé Studios 1946). (Shown many times every Christmas season).

the first step in a “loan to own” strategy.

Congress must recognize the marketplace reality of these competing interests, balancing the positive aspects of debtor reorganization against the legitimate needs and rights of lenders. Furthermore, Congress must also discard the rhetoric of those who have a vested interest in perpetuating the myth that the availability of DIP financing and its pricing are functions of rational measures of risk.

Some 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. The problem with this proposal is that the decision-makers who decide whether to file a Chapter 11 do not have an incentive to file early. In fact, they have every incentive not to file.<sup>36</sup> 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.<sup>37</sup> If the company files for Chapter 11 protection, these owner-managers will likely see their equity wiped out under the absolute priority rule,<sup>38</sup> 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<sup>39</sup> as well as the value of their stock and 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 reorganization is often lost.<sup>40</sup> 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 a sub-optimal aggregate systemic result.

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,<sup>41</sup> and the application of the absolute priority rule<sup>42</sup>, which often eliminates the equity interests in a Chapter 11 case, act as

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<sup>36</sup> Richard E. Mikels & 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>.

<sup>37</sup> *Id.* at 5.

<sup>38</sup> See 11 U.S.C.A. § 1129(b)(2)(B)(i-ii) (West 2011).

<sup>39</sup> *Lehman Brothers, Sharper Image, Bennigan’s and Beyond: Is Chapter 11 Bankruptcy Working: Hearing Before the H. Subcommittee on Commercial and Administrative Law*, 110th Cong. 18-24 (2008) [hereinafter *Lehman Brothers*] (Barry E. Adler, Esq., Professor, New York University School of Law) (citing Ayotte, K.M. & Morrison, E.R., “*Creditor Control and Conflict in Chapter 11*,” 2nd Annual Conference on Empirical Legal Studies).

<sup>40</sup> See *supra* note 37 at 5.

<sup>41</sup> 11 U.S.C.A. § 1121(b-c) (West 2011).

<sup>42</sup> See *supra* note 39.

a disincentive to earlier filing by debtors.<sup>43</sup> However, 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 that set dates by which reorganization plans must be submitted and confirmed. These provisions may require the sale of assets of the debtor by dates certain long before the expiration of the exclusivity period. Elimination of the absolute priority rule is problematic because creditors will contend, with some justification, that such a change would inequitably alter the negotiating balance away from creditors, and counterproductively result in tighter DIP restrictions by lenders to protect their interests.

#### IV. THE ARGUMENT AGAINST REDUCING DIP LENDER CONTROL

On one hand, many scholars and practitioners have expressed concern that DIP financing is not working effectively, 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 argument is that existing levels of DIP lender control over the bankruptcy process do not amount to bad policy, but instead function as part of a relatively efficient (though admittedly imperfect) market that channels human, physical, and financial capital towards its most productive uses. From this perspective, the system is working as well as can be expected, given the sudden collapse of the credit markets and the financial sector, as well as the ongoing recession. After all, “[b]ankruptcy is uniquely Darwinian”<sup>44</sup> in that it adapts to current economic conditions. It may be more accurate to attribute unprecedented high levels of Chapter 11 liquidations to market-driven phenomena and unexpected financial disruptions, rather than *de facto* legal changes such as DIP lender dominance of 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.<sup>45</sup> 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.<sup>46</sup> 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.<sup>47</sup> In addition, the managers who oversaw the

<sup>43</sup> See *supra* note 37 at 5.

<sup>44</sup> Matt Miller, *From Liquidity to Liquidation*, THE DEAL MAGAZINE (September 11, 2009, 1:52 PM), <http://www.thedeal.com/newsweekly/features/from-liquidity-to-liquidation.php>.

<sup>45</sup> *Lehamn Brothers*, *supra* note 40, at 20-21 (Congressional Testimony of Barry E. Adler).

<sup>46</sup> LoPucki, L. Doherty, Joseph W., *Why Are Delaware and New York Bankruptcy Reorganizations Failing*, 55 *Vanderbilt L. Rev.* 1933 (2002).

<sup>47</sup> *Id.*

descent of a company into bankruptcy frequently remained in control of the debtor during bankruptcy, and sometimes after.<sup>48</sup>

In contrast, in the new era of creditor dominance in Chapter 11, when a company files for bankruptcy the primary secured creditor characteristically wrests control of the case immediately from the debtor's managers.<sup>49</sup> 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.<sup>50</sup> Consequently, top managers now lose their jobs almost three-quarters of the time, and the bankruptcy process is commonly converted from a protracted negotiation to an efficient liquidation.<sup>51</sup>

Without denying the costs that liquidation imposes on suppliers, employees, and local communities, advocates of the status quo point out that a new financial structure will not rehabilitate a business that is not economically viable.<sup>52</sup> Firms do not enter bankruptcy randomly.<sup>53</sup> Many, perhaps most, fail for the old-fashioned reason: a poor business plan poorly executed. Filing for Chapter 11 cannot help a company that offers an expensive product that customers do not want.<sup>54</sup> Society is not well served if a futile reorganization attempt consumes resources the creditors could otherwise reinvest, while merely delaying the inevitable demise of the business.<sup>55</sup>

Moreover, cases like *First Magnus*<sup>56</sup> show that bankruptcy courts continue to scrutinize DIP financing agreements in light of the facts, circumstances, and economic context and retain the power to reject lender overreach, as they deem appropriate. In *First Magnus*, a case 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. The exchange was also for a super priority lien over all administrative expense claims and unsecured claims, a first priority security interest in all debtor's assets and proceeds,<sup>57</sup> and a provision stating that interested parties could not

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<sup>48</sup> *Id.* at 20.

<sup>49</sup> *Testimony of Barry E. Adler* (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)).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* at 21.

<sup>52</sup> *Id.* at 22.

<sup>53</sup> *Id.*

<sup>54</sup> *Supra* note 50, at 22.

<sup>55</sup> *Id.*

<sup>56</sup> *In re First Magnus Fin. Corp.*, 390 B.R. 667 (Bankr. D. Ariz. 2008).

<sup>57</sup> "The DIP Financing Motion." *In re First Magnus Fin. Corp.*, p.16-17 (Bankr. D. Ariz. August 21, 2007); See

object to approval of the DIP financing facility based on the adequate protection provided for in the agreement.<sup>58</sup>

The court denied the DIP financing facility on several grounds including the overreaching by the DIP lender, the potentially adverse impact on prepetition secured creditors, and the “overly expensive credit.”<sup>59</sup> The court calculated the effective cost of the loan, after fees and interest, as \$3,922,500, or 26.15% of the loan.<sup>60</sup> 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 above, while 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*<sup>61</sup> 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.<sup>62</sup> Roughly \$215 million of this loan was designated to pay a different prepetition lender, and the estate received approximately \$185 million in new money.<sup>63</sup> Although the DIP lender exercised some control in *General Growth Properties*, this control is less invasive than in other cases discussed above, and the debtor’s prospects for reorganization have not been impeded.<sup>64</sup> 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 under-collateralized, then the lender experiences 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 reorganization. Lenders also contend that increased risk will result in higher credit cost and limited availability of DIP credit to debtors. These considerations must be balanced with the overall objective of

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also O’Neil, Patterson, & Warner, *Current Developments in DIP Financing, Absolute Priority, and Pre-Confirmation* 363 *Sales*, 2009 Southwest Bankruptcy Conference, American Bankruptcy Institute, Sept. 10-12, 2009, p. 513-515.

<sup>58</sup> “The DIP Financing Motion,” at 20.

<sup>59</sup> “The DIP Financing Order.” *In re First Magnus Financial Corp.*, p.1 (Bankr. D. Ariz. August 21, 2007).

<sup>60</sup> *Id.*

<sup>61</sup> *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 46 (Bankr. S.D.N.Y. 2009).

<sup>62</sup> “The DIP Order.” *In re Gen. Growth Props.*, p.11-12 (Bankr. S.D.N.Y. April 16, 2009); *See also* O’Neil, *supra*, note 60, at 523.

<sup>63</sup> “The DIP Order,” at 7.

<sup>64</sup> *See* Daniel J. Sernovitz, *General Growth File Reorganization Plan*, BIRMINGHAM BUSINESS JOURNAL (July 13, 2010, 2:44 PM), <http://www.bizjournals.com/birmingham/stories/2010/07/12/daily16.html>.

reorganization.

A key function of Chapter 11 is to distinguish between firms that have failed and those that are merely in financial distress.<sup>65</sup> Indeed, when an economically failed company 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.<sup>66</sup> 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.

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<sup>65</sup> *Circuit City*, *supra* note 2, at 47 (Congressional Testimony of Todd J. Zywicki).

<sup>66</sup> *Id.*