The use of DIP financing as a mechanism to control the US corporate restructuring process*

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Introduction

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

State of the art – circa 1989

Even scholars who praise the benefits associated with economically efficient liquidity events (ie, liquidations or going concern sales) acknowledge that Chapter 11 has changed dramatically, from a paradigm of court-supervised reorganisation 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 reorganisations 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 reorganisation process than ever before.

The widely discussed case of *Tenney Village*[2] 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.[3] The proposed DIP financing agreement would have given the bank substantial control over the debtor as well as the Chapter 11 process, including:

- bank approval of the specifications for the debtor's planned improvements;
- direct supervision by the bank's consultant of the debtor's work on improvements;
- the right to require the debtor to hire a new chief executive, subject to approval by the bank;
- bank approval of the debtor's plan to market the condominiums;
- bank approval of a new marketing firm hired to market the condominiums;
- specific minimum unit values for sales of condominiums;
- 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;
- granting highest administrative expense priority to the bank's claims;
- vacating the automatic stay to permit foreclosure by the bank if any 'termination event' occurred, such as (i) a plan of reorganisation 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
- 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 troubling[5] because it was a roll-up that granted the bank a mortgage securing the outstanding pre-petition debt (roughly US$16,600,000) and the post-petition debt (US$1,000,000 in new money).[6] Further, the term of the loan was short – the entire debt was due roughly five 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 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 violated numerous Bankruptcy Code provisions.

How the world has changed over 20 years

Today, *Tenney*-style DIP financing agreements are commonplace. For example, in *Yellowstone*,[10] the debtor operated an exclusive, membership-based ski resort. The court approved a DIP loan (at 15 per cent 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 US$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 reorganisation within seven months, filing the plan within eight months, and confirming the plan within 11 months. The cost of interest plus fees was 20 per cent. Similarly, in *Reader's Digest*,[14] the DIP lenders were among the senior prepetition lenders who were owed US$1.6 billion. The DIP lenders provided US$150 million in new money, at an aggregate rate of at least 14.5 per cent interest (based on a LIBOR floor), and thereby obtained significant control of the reorganisation process, to the extent that they required the debtor to file a Chapter 11 plan of reorganisation 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).[15] Further, in *Propex*,[16] the initial DIP loan expired, and the initial DIP lenders refused to extend the maturity date and provide exit financing.[17] 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.[18] Consequently, the DIP lender was able to purchase the company, while earning US$3 million in fees, for a US$65 million DIP and exit facility with an interest rate of LIBOR plus ten per cent.[19] Finally, in the *Square Mile Energy* case in Houston the effective rate of the DIP loan was eight per cent per month (ie, 96 per cent annual interest).

While each of the foregoing cases is merely illustrative, the trend is toward DIP lenders using DIP financing as an ever increasing lever to gain control of the bankruptcy process. This explains how DIP lenders have taken control of many aspect 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.

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.

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 reorganising businesses in order to preserve jobs, benefit the communities in which businesses are located, and thereby serve our national interest in having a vibrant economy.[20] Chapter 11 was designed to be a tool to restructure the capital structures 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 policy perspective, businesses may be regarded as more than the sum of their financial, human and physical capital. Successful businesses take years to build, sustain relationships that have been developed over time as the result of effort and integrity, and 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 by legal roadblocks and market practices that hinder the rehabilitation of distressed companies, particularly those companies whose capital structures require reorganisation 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 recognised 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.

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 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.

Notes

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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?' 11 March 2009 (the 'Congressional Testimony of Prof Todd J Zywicki'), at 47, accessed on 28 October 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 *Ibid*, at 563.

4 *Tenney* at 567.

5 S*ee 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 *Ibid*, at 567.

8 *Ibid*, at 568.

9 *Ibid*, at 568.

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

11 *Ibid*, at 19-20.

12 *Ibid*, at 20.

13 *In re Lyondell Chemical Co*, Case No 09-10023 (Bankr SDNY 11 January 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, 1-2 October 2009, at 18.

14 *In re The Reader's Digest Association, Inc*, Case No 09-23529 (Bankr SDNY 24 August 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] (24 August 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.

17 Hesse and Laber, at 21.

18 *Ibid*, at 21.

19 Hesse and Laber, at 21.

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?' 11 March 2009 (the 'Congressional Testimony of Harvey R Miller'), at 12, accessed on 28 October 2009 at: **http://judiciary.house.gov/hearings/hear_090311_1.html**.

21 *Ibid*, at 12-13.

22 Congressional Testimony of Harvey R Miller at 13.