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Feature

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The Lender Games


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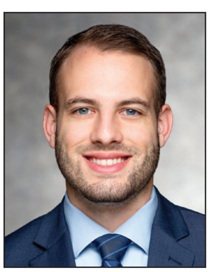
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Although post-petition debtor-in-possession (DIP) financing is standard practice in today's marketplace, the terms of that financing are anything but regular, and the landscape continues to evolve. Evolving trends in DIP financing — advanced by innovative lenders and shrewd debtors — have invited deeper scrutiny by courts in recent years. This article identifies and analyzes these trends, focusing on the concessions, compromises and outright rejections of various provisions of DIP financing over the last year.

The injection of new capital through DIP financing is often necessary: It enables greater returns for all creditors by permitting the company to continue as a going concern, and signals to the market that the debtor has the support of lenders to effect a reorganization.

DIP financing has always offered lenders lucrative returns based on relatively high interest rates and fees. Over the years, lenders have become increasingly creative in their efforts to achieve higher returns by implementing favorable provisions in DIP facilities.

The Evolving Lender Base

The commercial banks that historically dominated the DIP-financing industry are now competing against strategic and alternative lenders that are interested in high yields or acquiring distressed companies through debt transactions. While banks generally approach DIP lending on a holistic level, with the goal of building a lasting relationship, alternative lenders often approach lending with the goal of creating value through short-term deals or equity ownership.

The shift in lender base from commercial banks to alternative lenders has led to a corresponding shift in the structure of DIP financing. Concentrating heavily on loan yields, alternative lenders frequently structure DIP loans as term loans rather than unfunded revolvers, which had previously been the relative standard in DIP loans. Unfunded revolvers allow debtors to borrow and repay funds as needed over the course of a chapter 11 case, giving them the flexibility to manage interest costs. The reduced use of unfunded revolvers has largely eliminated this flexibility. With the inclusion of a term loan component in any DIP-financing package, debtors are required to pay interest on the entire loan rather than just the capital under the revolver. Looking for larger returns on higher yields, increased security and speedier recoveries, DIP facilities have evolved to implement novel terms that aim to build value while guiding related aspects of the case.

The DIP Sheriffs

Bankruptcy courts evaluate DIP financing arrangements using the framework outlined in section 364 of the Code.[1] No two DIP facilities are the same, and with so many terms, provisions and unique characteristics, no two judges are likely to focus their attention on the exact same provisions. With innovative lenders increasingly testing the waters with more creative terms and case-guiding features, the role of watchdog typically falls on the unsecured creditors' committee and the U.S. Trustee. Nevertheless, a bankruptcy judge must ultimately approve every proposed DIP order, and some judges choose to be very actively involved when it comes to approving the DIP financing.

Local rules and standing orders frequently require debtors to highlight potentially controversial provisions, including cross-collateralization, priming liens, waiver of § 506(c) rights, grants of liens in avoidance actions and findings related to the validity or perfection of liens. Other issues subject to heightened scrutiny include the size of the DIP financing package, the availability of alternative financing, whether pre-petition debt is "rolled-up" in the DIP protections,[2] the degree of lender control over the case, and fees.

1 11 U.S.C. § 364.
2 Under a "rollup" DIP, pre-petition debt is converted to post-petition debt, effectively giving the pre-petition debt the protections afforded to the post-petition financing and improving the position of the pre-petition lender.

Size Matters

Judges are skeptical of DIP financing packages that are either insufficient to keep the estate administratively solvent or, in the alternative, exceed the needs of the debtor. For example, in *Orchid Paper Products Co.*, in response to arguments from the unsecured creditors' committee that a heavily restricted $11 million DIP facility was insufficient to pay existing administrative expenses, including post-petition trade payables, Hon. **Mary F. Walrath** rejected the debtor's request for final approval of the DIP facility.[3]

Judges are equally skeptical of lenders attempting to finance more than the debtor needs. In *SportCo Holdings Inc.*, the debtors sought permission to access $15 million in DIP financing.[4] Hon. **Laurie Selber Silverstein** found the amount of the facility unnecessary, citing the debtors' recent positive cash flow.[5] The lender appeared to be lending more than was necessary to capitalize on accruing additional interest payments. Judge Silverstein reduced the loan amount to $10 million, delaying further amounts until necessary.[6]

No Alternative Financing Available

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Judges' flexibility to challenge overreaching DIP provisions are sometimes hamstringed by a lack of viable alternatives. Section 364(c) of the Bankruptcy Code requires a debtor seeking post-petition financing on a secured basis to demonstrate an inability to obtain financing on more favorable terms.[7] Beyond this threshold, the availability of other secured financing can greatly influence the terms of the final DIP facility. Facing the predicament of permitting overreaching provisions versus leaving a debtor in a liquidity crisis, judges have sometimes voiced their concerns about certain provisions being approved, acknowledging that their approval hinged on the lack of other financing. It is not clear what weight this absence carries, but it certainly assists in pushing the pendulum in the lenders' favor.

In a clear example, Hon. **Kevin J. Carey** (now retired) approved approximately $1.2 billion in DIP financing for the bankrupt ATD Corp., which included, among other things, a $639 million rollup.[8] The rollup was "extraordinary" and gave Judge Carey "pause" when reviewing the amount of the facility.[9] The debtor recognized the rollup as not being the "preferred approach in the district."[10] However, citing a lack of alternative financing and a proposed restructuring-support agreement with the majority of unsecured noteholders' support, Judge Carey approved the DIP financing over the objection of the U.S. Trustee.[11]

In a more recent and "creative" financing structure, the *Hexion TopCo* debtors made an unusual request: For a nondebtor affiliate to secure $700 million in DIP financing, the debtors pledged a large number of their unencumbered assets.[12] The U.S. Trustee objected on the grounds that $350 million would initially be borrowed by a nondebtor who would then use it to pay off pre-petition debt owed by both debtor entities and nondebtor foreign affiliates through a complex series of intercompany transactions. The debtors argued that this structure would "take advantage of substantial pockets of unencumbered value to secure the financing they need[ed] on what is effectively a non-priming basis."[13] The unencumbered value, paired with support of the vast majority of secured creditors, as well as a declaration detailing a "robust marketing process for DIP financing," proved enough to satisfy the court. Although this structure was unusual, Hon. **Kevin Gross** approved the financing, finding that it was necessary and no better financing was available.[14]

The determinative factor in each of these cases was the lack of alternate financing and the "reasonable commercial" efforts made by the debtors pre-petition in marketing such financing. If the choice facing bankruptcy judges is approving the proposed DIP financing, despite potential lender overreaching versus denying financing to the debtor, judges tend to permit the onerous financing arrangement to move forward at the risk of thwarting the debtor's chance of reorganizing (even if they may note their reservations about the financing on the record).

Rollup in Proportion to New Money

Despite judges' general reluctance to permit the rollup of pre-petition debt, rollups have become a common feature of DIP facilities and the debate has moved to how much will be rolled up. The pace at which the pre-petition debt is rolled up appears to play a substantial role in how large of a rollup will be approved and how much new money is required. In *Kona Grill Inc.*, the DIP agreement called for $6 million in a new money term loan and a $33.2 million rollup to occur primarily on a "creeping" basis.[15] That is, rather than drawing on the DIP facility to pay down the pre-petition debt, the debtors agreed to pay the pre-petition debt over time from the debtors' working capital. Hon. **Christopher S. Sontchi** said he was "not disturbed" that a creeping rollup of pre-petition debt was being

3 Tr. of Record, *In re Orchid Paper Prods. Co.*, No. 19-10729 (MFW) (Bankr. D. Del. May 30, 2019), ECF No. 213 at 173.

4 *In re SportCo Holdings Inc.*, No. 19-11299 (MFW) (Bankr. D. Del. June 11, 2019), ECF No. 34-1 at 20.

5 Tr. of Record, *In re SportCo*, No. 19-11299 (MFW) (Bankr. D. Del. June 11, 2019), ECF No. 49 at 38-40.

6 *Id.* at 79.

7 11 U.S.C. § 364(c).

8 *See In re ATD Corp.*, No 18-12221 (KJC) (Bankr. D. Del. Oct. 5, 2018), ECF No. 109.

9 Tr. of Record, *In re ATD*, No 18-12221 (KJC) (Bankr. D. Del. Oct. 5, 2018), ECF No. 166 at 50.

10 *Id.* at 40.

11 *Id.* at 46-51, 60.

12 *See* Interim DIP Motion, *In re Hexion TopCo LLC*, No. 19-10684 (KG) (Bankr. D. Del. April 1, 2019), ECF No. 62, at 3-4.

13 *Id.* at 4.

14 Tr. of Record, *In re Hexion*, No. 19-10684 (KG) (Bankr. D. Del. April 2, 2019), ECF No. 107 at 38.

15 *See* Interim DIP Motion, *In re Kona Grill Inc.*, No. 19-10953 (CSS) (Bankr. D. Del. May 1, 2019), ECF No. 15-1.

used in the chapter 11, as "it's not a lot of money."[16] While $6 million might not be a lot of money in this context, the amount of new money was only about 15 percent of the total DIP amount. Although Judge Sontchi couched his approval in his ability to revisit the rollup in the final DIP order, the inclusion of adequate protection to pre-petition lenders through replacement liens and a superpriority administrative-expense claim likely swayed his decision in pushing this DIP through. Notably, no alternative financing was available to the debtors.[17]

The same facts applied proportionately to a much larger bankruptcy might prompt different commentary. However, the use of a creeping rollup as compared to a full rollup might play a role in avoiding any judicial angst. A creeping rollup puts less stress on the debtor's finances by gradually converting pre-petition debt into post-petition financing. Therefore, DIP lenders might reach more favorable decisions in situations when they are investing little new money if choosing to structure rollups in a more gradual form.

Lender Control of the Case

Another recent concern that courts have flagged is the ability of DIP lenders to lock in key aspects of the case before the case has begun to unfold. In *Hollander Sleep Products LLC*, the debtor proposed $118 million of DIP loans from its pre-petition lenders, conditioned on significant liability releases, detailed case milestones, provisions barring the debtor from seeking other financing sources and other broad restrictions.[18] In finding these limitations excessive for an interim order, Hon. **Michael E. Wiles** demanded a rewritten proposed interim DIP order, requesting "less all-consuming and all-controlling ... first-day orders."[19]

Judge Wiles expressed concerns that the DIP order would lock down too many aspects of the case without giving the unsecured creditors' committee and other unsecured creditors an opportunity to object.[20] He also specified that the new version of the DIP motion should not be conditioned on enacting any part of the pre-petition restructuring-support agreement, stating, "I won't approve a restructuring agreement by the back door."[21] Judge Wiles eventually approved a substantially revised interim DIP order, which eliminated, among other things, the significant liability releases, approval of certain fees, a blanket collateral term, a milestones provision and other broad protections for the DIP lender, DIP agent and other pre-petition secured parties.[22]

Built-In Fees

Courts also have begun to examine fees closely and have refused to approve DIP-financing arrangements where fees deviate too far from the market. In *F+W Media Inc.*, the debtors proposed a DIP calling for a 20 percent or $1.6 million closing fee on an $8 million term loan.[23] The unsecured creditors' committee objected, calling the closing fee excessive and requesting that it be reduced to 5 percent. Judge Gross agreed, barring the DIP lenders from charging a 20 percent closing fee, also calling it "excessive" and cutting the fee to 10 percent.[24] Similarly, in *Sugarfina Inc.*, Judge Walrath rejected a debtor's request to draw on its financing, finding an 8 percent annual interest rate, a 7 percent success fee and a repayment premium to be "offensive," citing the effective annualized interest rate to potentially exceed 50 percent.[25]

Assessing multiple lower-percentage fees might allow lenders to collect on both the front and back end of a deal while also earning a relatively favorable DIP interest rate. This strategy was successfully deployed in *Kona Grill Inc.*, where the lender maximized its returns by implementing a 2 percent unused fee, 2 percent facility fee and 2 percent exit fee for all new money loaned to the debtor.[26]

What's Next?

Lenders' creativity in DIP financing will likely further pave the way for larger and more elaborate DIP-financing agreements. Lenders will continue to evaluate what works and what does not, proposing DIPs with terms that walk a fine line between the two.

As parties continue to navigate these complex financing arrangements, judges will continue to face the dilemma of approving a financing package that may give them "pause" versus frustrating a debtor's opportunity at reorganizing. However, the potentially lucrative market for DIP financing may work against these lenders, creating greater competition and forcing them to offer more favorable terms. abi

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16 Tr. of Record, *In re Kona*, No. 19-10953 (CSS) (Bankr. D. Del. May 2, 2019), ECF No. 76 at 30.

17 Declaration of Christopher J. Wells, *In re Kona*, No. 19-10953 (CSS) (Bankr. D. Del. May 1, 2019), ECF No. 16 at 19.

18 *See* Interim DIP Motion, *In re Hollander Sleep Prods. LLC*, No. 19-11608 (MEW) (Bankr. S.D.N.Y. May 19, 2019), ECF No. 13.

19 *See* Rick Archer, "Hollander Ch. 11 Needs Less Restrictive DIP, Judge Says," *Law360* (May 21, 2019), *available at* law360.com/articles/1161982/hollander-ch-11-needs-less-restrictive-dip-judge-says (subscription required to view article; unless otherwise specified, all links in this article were last visited on Sept. 27, 2019).

20 *Id.*

21 *Id.*

22 *See* Interim DIP Order, *In re Hollander*, No. 19-11608 (MEW) (Bankr. S.D.N.Y. May 23, 2019), ECF No. 53.

23 Interim DIP Order, *In re F+W*, No. 19-10479 (KG) (Bankr. D. Del. March 10, 2019) ECF No. 13, at 8.

24 Tr. of Record, *In re F+W*, No. 19-10479 (KG) (Bankr. D. Del. March 19, 2019) ECF No. 57, at 55-56.

25 *See* Vince Sullivan, "Candymaker's Ch. 11 Loan Stifled by Court's Issues with Fees," *Law360* (Sept. 9, 2019), *available at* law360.com/articles/1196975/candymaker-s-ch-11-loan-stifled-by-court-s-issues-with-fees.

26 *See* Final DIP Order, *In re Kona*, No. 19-10953 (CSS) (Bankr. D. Del. May 28, 2019), ECF No. 165.