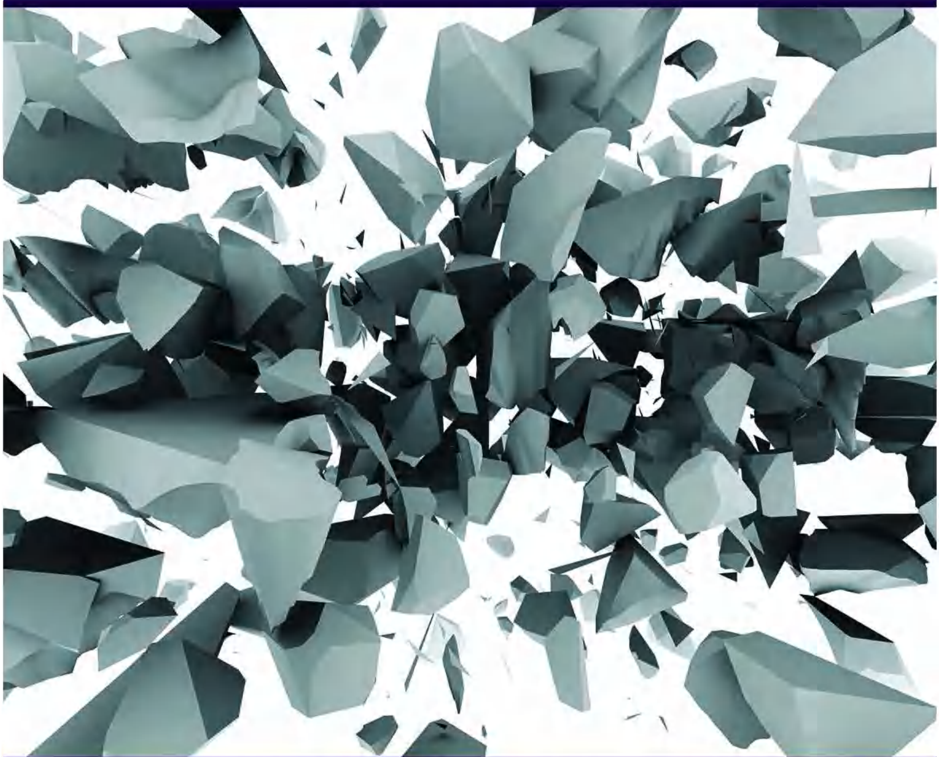
RESEARCH HANDBOOK ON
Corporate Bankruptcy Law

Edited by
Barry E. Adler



RESEARCH HANDBOOKS IN CORPORATE LAW AND GOVERNANCE
Series Editor: **Randall S. Thomas**

RESEARCH HANDBOOK ON CORPORATE BANKRUPTCY LAW

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8. Debtor-in-possession financing in bankruptcy

George Triantis

I. INTRODUCTION

Though its origins date back to the equity receiverships of railroads in the late 19th and early 20th centuries,[1] debtor-in-possession (DIP) financing has emerged over the past few decades as an essential component of corporate bankruptcy reorganization. Most debtors who file for bankruptcy do so because they lack the liquidity with which to continue to operate – that is, they neither have liquid assets nor readily available credit. By the conclusion of the bankruptcy process, this liquidity problem is addressed by the financial reorganization of the debtor, the sale of its assets, or both. However, this process takes time and during this time, the debtor needs working capital to continue to operate and preserve its value. Upon the filing of the petition, the automatic stay on creditor enforcement provides relief from the threats of asset removal by creditors and contract termination. In addition, the bankruptcy court may authorize the debtor to use cash in its possession or control, such as its checking account, despite the objection of the lender holding a lien against such collateral. These forms of relief, however, are often insufficient because the debtor needs fresh financing to continue to operate. In other words, although the bankruptcy process itself is designed to yield ultimately a solvent and liquid debtor, most debtors cannot wait for this process to develop without having access to liquid assets or credit. The typical debtor has an immediate need for working capital and liquidity at the outset of the case, in order to finance the reorganization process and avoid value-destroying piecemeal liquidation. Not surprisingly, therefore, judicial authorization of interim DIP financing is among the common first-day motions of a Chapter 11 case and is often followed by at least one more round of authorized financing before the debtor emerges from bankruptcy.[2] Indeed, obtaining a line of credit shortly after filing is a favorable signal of the debtor's prospects in bankruptcy and many debtors get larger credit lines than they expect to draw on.

Under the governance scheme of the Bankruptcy Code, the bankruptcy court must authorize decisions made out of the ordinary course of business. Section 364 gives the bankruptcy court discretion over DIP financing. The provision allows the court to facilitate new borrowing by authorizing the debtor to grant the DIP lender priority ranging from administrative expense to junior and senior secured credit. However, the statute permits secured borrowing only if the court finds that credit would be unavailable without such priority. If the secured credit is senior to a prepetition lien, then the debtor must also ensure "adequate protection" of the subordinated prepetition lien – that is, the debtor must provide assurance that the granting of the superior lien does not harm the economic interest of the subordinated prepetition lienholder.

Over the four decades since §364 was enacted in the 1978 Bankruptcy Code, the liabilities of corporations and the nature of liquidity constraints have become much more complex, as have the structures of DIP lending. Credit markets have grown much more diverse and sophisticated. The drafters of §364 envisaged that it would occasionally encourage existing creditors to loan new funds to the insolvent debtor in bankruptcy, but the current practice is much different. In the 1980s and early 1990s, fewer than one-third of the publicly-held debtors filing in Chapter 11 obtained DIP financing and this was mostly from prepetition lenders.[3] During the 1990s, a growing number of financial institutions began to look at DIP financing as a new business opportunity with low risk and profitable returns. The syndications market also matured and syndicated DIP loans became more common in this period. These market trends opened up further options. The proportion of debtors in bankruptcy taking DIP loans grew to about a half by the end of the decade and up to 70% range in the 2000s.[4]

DIP lending also became a tool by which some creditors have increased their control over bankrupt firms. Over the past decades, lenders have been taking broader security interests covering almost all assets of distressed debtors, thereby tightening constraints on liquidity and heightening the urgency for DIP financing in a larger proportion of bankruptcy cases. DIP loan terms contain restrictive negative and affirmative covenants, similar to – but often more intrusive than – those that address moral hazard concerns in debt relationships outside of bankruptcy. In fact, DIP covenants commonly set budgets, targets and deadlines that constrain the debtor's discretion and influence over the course of the bankruptcy process, especially given that the debtor can and does typically waive the bankruptcy stay on acceleration and enforcement of postpetition loans. Also, since the turn of the century, some DIP lenders have been motivated to lend in order to improve their prospects for acquiring the debtor's assets or ownership interests in the reorganized company. The contracts with such "loan-to-own" lenders often include deadlines for auctions or closings of asset sales or for the filing of a reorganization plan and disclosure statement.

The bankruptcy court has the important discretion to order or deny authorization for the DIP financing arrangement proposed by the debtor. Although most DIP financing arrangements are made with the consent of the unsecured creditors' committee and principal secured creditors, the judicial determination of contested motions sets the defaults for these negotiations. The language of section 364 instructs the court to authorize a §364(d) loan only if credit would be unavailable otherwise and the prepetition lien subordinated (or "primed") by the proposed DIP loan is adequately protected. As discussed in Part II below, new credit for a debtor is not always a good thing and it is inefficient if it props up a nonviable operation (sometimes referred to as "overinvestment"). The court must ensure that funding is authorized when, and only when, it is efficient – in other words, when value is created or preserved so that no party is made worse off as a result of the DIP financing.[5] A related objective is ensuring that the terms of DIP finance are as competitive as possible. Outside bankruptcy, the presence of a prepetition secured creditor can deter other prospective lenders from offering new credit under a subordinate lien. By permitting the priming of the prebankruptcy lien, §364(d) encourages bids by new lenders and thereby reduces the ability of the prebankruptcy secured creditor lender to extract a supernormal rate of return in return for new financing.

As discussed below, courts should bear in mind these objectives in deciding, for example, whether to permit extraordinary terms such as cross-collateralization and roll-ups. Moreover, although the language in §364 focuses on priority, the court must also assess whether all the significant terms of the DIP loan are in the best interests of the estate. Thus, bearing in mind the two objectives identified above (permitting only value-creating new finance and at a competitive rate of return), the court must scrutinize the rate of interest and contractual events of default, as well as the priority. To date, bankruptcy courts have not ordered explicit bidding contests among prospective lenders, in the way that they order auctions of assets under §363(b) or of the equity interest in the reorganized debtor in a cramdown, as instructed by the U.S. Supreme Court opinion in *North LaSalle*.[6]

The acceptable conditions and terms for DIP loans have been subject to a considerable policy debate. This discussion has been informed by some empirical study of DIP financing patterns and their relationships to bankruptcy outcomes. A number of studies suggest a positive correlation between DIP financing and the emergence from Chapter 11, particularly in the important jurisdictions of Delaware and the Southern District of New York.[7] The mechanics of the relationship between financing and outcome, however, are unclear. Even if DIP lending has been beneficial overall, there remains an unresolved debate as to the effect of certain specific features.

In 2014, the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 proposed significant restrictions on several types of provisions that can be included in DIP financing arrangements, particularly at the interim order stage.[8] These provisions include cross-collateralization, roll-ups, liens in avoidance actions, waiver of avoidance claims against the DIP lender, deadlines for the sale of assets or the filing of a reorganization plan. The Commission's position was that these provisions are not necessary for a robust supply of DIP financing and each can lead to inefficient decisions that inflict losses on prebankruptcy creditors. In an opposing submission to the Commission, the Loan Syndications and Trading Association argued that the proposed limitations would raise the cost of DIP loans for some debtors and make them unavailable for others. These conflicting and core assumptions have not been tested and are difficult to prove empirically.

II. LIQUIDITY, FINANCIAL SLACK AND DEBT OVERHANG

Liquidation priority is a core feature of debt contracts. Creditors have the right to be paid before stockholders, and priority among debt claims is hierarchical as against either individual assets or the debtor as a whole. The priority ranking among creditors may be created by contract or the grant of a property interest. In the contractual form, one creditor consents to be subordinate to another in its claim against the debtor. A debtor's promise to cap its borrowing or refrain from granting future liens on its assets (known as a negative pledge covenant) is a weaker contractual provision because it is only binding against the debtor and not the future lien creditor who would assert its priority. Shorter-maturity debt – whether short-term liability or debt maturity that can be accelerated under tight covenants or cross-default clauses – has effective priority over longer-term debt because it comes due earlier.

The debtor may give priority to a creditor by granting a property interest: specifically, a lien, mortgage or security interest in some of its assets (collateral). Article 9 of the Uniform Commercial Code enables security interests in a broad range of personal property, including bank deposits and cash. The secured creditor or lienholder enjoys a superior claim to the value of the collateral asset, and the right to be paid from this asset before all unsecured creditors. Among competing liens in the same collateral, priority is determined generally according to the time at which each creditor publicizes her lien by possession or registration. Another property-based form of priority is created in a parent-subsidiary corporate group structure, where the creditor of an operating subsidiary has structural priority over the creditors of the holding company. The latter creditors have rights against the parent's stock in the subsidiary, which is subordinate to the subsidiary's creditors.

Debt – and particularly secured debt – constrains the debtor's ability to fund its operations or new projects in various ways.[9] The repayment obligations remove cash from the debtor periodically and if the debtor defaults, a secured creditor can move quickly to freeze the debtor's access to liquid assets. In addition, security interests make it difficult to convert illiquid into liquid assets because, in a sale outside the ordinary course of business, the lien follows the asset into the hands of the transferee. Thus, prospective purchasers are reluctant to buy encumbered assets.

A highly levered company will find it more difficult to raise new financing than a similarly situated firm with less debt. A company with a larger share of assets encumbered by liens will find it more difficult than one whose debt is largely unsecured, all else equal. The term "debt overhang" describes the condition in which the debtor cannot raise new capital to finance a profitable and low-risk project because the payoffs from that project will be absorbed first by (or in the case of unsecured debt, shared with) the earlier creditors who cannot be paid their return out of the value of existing assets. This leaves an inadequate return for the new investor.[10] The overhang problem can be overcome if the firm can issue debt with higher priority than its existing liabilities,[11] but this is difficult to do if the debtor has encumbered most or all its assets with security interests that rank in priority on a first-in-time basis. A better regime might provide that the later-in-time lender has priority only to the extent that she contributes new value. This can and is achieved when the new lender finances the acquisition of a discrete asset (through a "purchase money security interest"), but not when it adds value to existing assets (such as by paying the utility bills).[12]

Liquidity can be a good or bad condition depending on contextual variables. In a company with abundant profitable investment opportunities, liquidity is good because it enables the firm to exploit those projects promptly, especially in an environment when cash flow is otherwise volatile. In a company with few or no profitable opportunities, liquidity provides management with financial slack to promote its self-interest rather than maximizing firm value (for example, through perquisite consumption or as a forgiving buffer for poor or inattentive management). Debt – and particularly debt secured by broad security interests – serves the function of constraining financial slack[13] (Triantis 1995[14]), but it can also constrain the liquidity necessary to invest in profitable opportunities, such as the continuation of efficient operations. Outside of bankruptcy, security interests that are publicized (usually by registration) have priority over later security interests and thereby constrain future financing prospects. The principal exception to this general first-in-time priority rule is the purchase money security interest, but it applies narrowly to the financing of a specific discrete asset as opposed to working capital. So, a blanket lien over the debtor's assets has an indiscriminate effect on future financial prospects: it can discourage either efficient or inefficient future financing[15] (Triantis 1995[16]). Optimally, a company would set the amount and priority of debt in the capital structure of a firm to preserve the liquidity needed to make all profitable investments but no more. However, over time, circumstances change, causing the liquidity settings to be looser or tighter than optimal. If a leveraged company has a lower cash flow than expected but its operations continue to be profitable, for example, it faces a liquidity problem that can lead to inefficient cessation of operations.

A debtor that files for bankruptcy is typically one that cannot fund its ongoing operations. Over the past few decades, illiquidity and debt overhang have become more severe among these firms. The proportion of asset value covered by liens has grown so that many firms entering into bankruptcy have few if any unencumbered assets.[17] Many have postponed bankruptcy filing by drawing down on revolving credit facilities secured by blanket liens.[18] One of the fundamental goals of bankruptcy is to relieve the overhang of existing obligations and restore desirable levels of liquidity.[19] Reorganization under the Chapter 11 process reduces the debt obligations of the debtor so that it emerges from bankruptcy solvent and with adequate liquidity. This is accomplished largely by forcing the recapitalization on dissenting creditors through supermajority voting and judicial cram down. In light of the fact that Chapter 11 cases take time and liquidity needs are typically urgent, the Bankruptcy Code enables the funding of operations during the process, with financing that is repaid when the debtor emerges from bankruptcy. These provisions give the bankruptcy court important discretion to authorize and condition the new funding when it is efficient and in the interests of the estate.

Before turning to the authorization of DIP financing, two related provisions in the Bankruptcy Code are worth mentioning in addressing the liquidity constraints of debtors. First, blanket security interests that extend to proceeds or products from collateral are enforceable in bankruptcy but section 552(b) of the Bankruptcy Code authorizes the court to limit this coverage, after notice and a hearing, "based on the equities of the case." The court may use this provision to limit the reach of prepetition liens if the proceeds and products are created by a mix of the existing collateral and new investment. This liberates assets to support new credit that would fund the operations.[20] Second, security interests often cover the debtor's bank deposits and cash holdings, subject of course to the aforementioned "equities" limit in §552(b). The ability of the secured party to take possession of these liquid assets, by set-off or otherwise, is frozen by the automatic stay in §362(a)(3) and debtors often move to authorize the use of such cash collateral.[21] This loosens the debtor's liquidity compared to what it would have been outside of bankruptcy.

"Adequate protection" plays a central role in bankruptcy as a condition of the debtor's continued use of collateral assets: such as in the judicial determination to continue the automatic stay or to authorize the use of cash collateral. Adequate protection vindicates the economic value of the property interests, particularly liens, of prepetition creditors. In addition, it provides a check to ensure that the debtor's use of the collateral is efficient. After all, if the use of the collateral creates value in the debtor's enterprise, the debtor should be able to ensure that the lienholder is no worse off. Section 361 of the Bankruptcy Code lists three ways by which the debtor could provide adequate protection. The first two – cash payment (§361(1)) and an additional or replacement lien in another asset (§361(2)) – are unlikely to be feasible because debtors typically file for bankruptcy with insufficient cash and little, if any, value in unencumbered assets. The courts have interpreted the third option (§361(3)) – such other relief as would result in the realization of the indubitable equivalent of the protected lien – as being satisfied by the presence of a significant equity cushion in the value of the collateral, particularly with prospects that the value will increase in bankruptcy. A common justification is that the debtor's use of the collateral will create sufficient value to ensure that the prepetition secured claimant is left no worse off, while the junior creditors benefit.

III. DIP FINANCING UNDER SECTION 364

a. DIP Financing Priorities and Priming Liens

Section 364 of the Bankruptcy Code provides a ladder of priority debt that the bankruptcy court can authorize if financing cannot be otherwise obtained. Under subsections 364(a) and (b), the debtor may obtain unsecured credit as an administrative expense in the ordinary course of business (unless the court orders otherwise) or, with judicial authorization after notice and a hearing, outside the ordinary course. Administrative expenses are paid prior to unsecured claims in liquidation, and they must be satisfied in full to confirm a reorganization plan. Under §364(c), after notice and a hearing, the court can authorize debt secured by an interest in unencumbered assets or by an interest junior to an existing lien in encumbered property, but only if the debtor is unable to obtain unsecured credit as an administrative expense.[22]

Finally, under §364(d), the court may authorize a lien that is senior or equal to an existing lien, but only if the debtor is unable to obtain such credit otherwise and the debtor demonstrates that the subordinated (or equal) prepetition interest is adequately protected. As noted earlier, debtors can demonstrate that lienholder interests are adequately protected by an equity cushion in the collateral value, particularly if the new financing will also enhance the value of the collateral. However, the two requirements for priming liens under §364(d) are in tension with each other. If a prebankruptcy secured claim can be adequately protected notwithstanding the priming of its lien, this begs the question of why the new financing could not have been obtained by offering a junior lien. For instance, if the prebankruptcy creditor has a claim of $60 secured by collateral worth $100, the DIP might propose a new priming loan for $20 and point to the $20 remaining cushion as adequate protection. However, the DIP must also argue that this cushion would have been inadequate to induce a new lender to provide $20 in credit with a junior lien. Similarly, if the DIP offers adequate protection in the form of a replacement or additional lien in unencumbered assets, it begs the question – and warrants some skepticism – as to why this collateral could not have supported the new DIP loan. This gives rise to the concern that the DIP financing authorization compels the primed lienholder to accept a risk that the debtor could not sell to a new lender.

Most DIP loans are secured by blanket liens over the debtor's assets and around two-thirds enjoy a §364(d) security interest.[23] As noted earlier, the two core objectives for the court in authorizing DIP financing are to ensure that the financing (a) creates rather than simply redistributes wealth and (b) is made on competitive terms. With the relaxation of the adequate protection requirement under the "indubitable equivalent" provision of §361, the first objective calls on the authorizing court to also assess the viability of the debtor and the efficiency of the use to which the funds will be put, including the debtor's business plan and the intended use of proceeds. The court performs a critical service in distinguishing between the two possibilities of value creation and expropriation: Does DIP financing correct underinvestment and create value or produce overinvestment and expropriate value from prebankruptcy creditors who are compelled to accept a higher risk without compensation?[24] The risk of overinvestment and expropriation of value is significant, especially when the DIP lender takes a higher priority. After all, from the DIP lender's perspective, a priming lien in all the debtor's assets is a relatively low risk irrespective of the feasibility of the debtor's operations and plans: the DIP lender is insulated from losses due to inefficient investment.[25] Overinvestment in risky projects enriches the shareholders, managers and underwater junior creditors who would gain if the project is successful, but compromises the expected payoff of the fulcrum or marginal creditors, who bear the cost of failure. The sharing of the benefit depends on the financial condition of the company, the risk profile of the project and the relative bargaining power of the DIP and the DIP lender.

The evidence of the relationship between DIP financing and bankruptcy outcomes is tentative. Several empirical studies find in their respective samples that companies with DIP financing were more likely to survive as going concerns, suggesting that the courts are performing their screening function well.[26] However, the causal link, if any, remains unclear. Are firms receiving DIP financing those that were already more likely to emerge in the first place, or does the DIP lender contribute screening or monitoring that materially improves those prospects? Are some features of DIP financing more likely to lead to emergence by funding value-creating expenditures and others more likely to redistribute wealth away from other creditors by continuing inefficient operations? The mechanism by which DIP financing creates value, if any, in bankruptcy is critical to the question of whether courts should allow certain controversial features of DIP financing that are discussed below.

The second objective of judicial oversight under §364 is to promote DIP lending on competitive terms, which should entail both ensuring that the debtor has sufficiently shopped the financing and examining the proposed lending arrangement.[27] In the majority of cases, the DIP lender presented to the court is also a prebankruptcy secured lender.[28] These creditors enjoy an advantage over other potential lenders because of their relationship and superior information about the debtor, and this may skew the court's determination. A debtor-in-possession is required to present evidence that it has sought out financing from several sources, but courts generally do not require a formal bidding process from prospective lenders. Although auctions have been increasingly used in other bankruptcy proceedings – such as asset sales under §363(b) – this has yet to become a requirement for §364 DIP financing authorizations. While a market test is required under the doctrine of the Supreme Court in North LaSalle before allowing the new capital from prebankruptcy owners to effectively "prime" prebankruptcy creditor claims in a reorganization plan, this is not required under analogous circumstances during bankruptcy under §364 authorizations.[29] In addition, as the supply of DIP financing expands, prospective DIP lenders may compete across different terms (priorities, interest, covenants, and so on), so that courts will be called upon to consider trade-offs across these term types. For example, they may need to compare the desirability of a priming lien against an alternative debt obligation with lower priority and a higher rate of interest. Although the lower interest rate offered with a more senior lien can be seductive, the courts should not ignore the implicit cost borne by the junior primed lienholder whose risk has increased.

b. Cross-collateralization, Roll-ups and Avoidance Protection for Prepetition DIP Lenders

Cross-collateralization and roll-ups are two features that debtors commonly propose and that entice prepetition creditors to provide DIP financing.[30] As discussed above, the priming of liens may mitigate underinvestment or exacerbate overinvestment, and the court plays an essential screening role in authorizing §364(d) priority. Cross-collateralization and roll-ups raise more severe concerns about overinvestment and there is controversy as to whether these features are needed to attract new funding for efficient investments, as opposed to those with negative expected net present values. Both features benefit DIP lenders by improving the return on their prepetition claims at the expense of other claimants.[31] Under cross-collateralization, the DIP provides a lien that secures in the agreement not only the new funds but also the prepetition claims held by the lender. Under a roll-up, the DIP loan provides funding to satisfy prepetition claims – often claims of the DIP lender – and to fund operations. The benefit to a DIP lender with an undersecured prepetition claim, and the corresponding loss to other unsecured creditors, is clear. It can also benefit the DIP lender with a secured prepetition claim if its prepetition lien is subject to a possible avoidance action or other challenges in bankruptcy, or to a crammed-down adjustment under a reorganization plan. Indeed, a DIP might alternatively waive its right to challenge liens or payments preceding bankruptcy or make representations to acknowledge the validity of the existing lien.

Cross-collateralization, roll-ups and avoidance protection encourage DIP lending through the benefit they confer onto prepetition claims, as opposed to the return on the new funding. To the extent that they are retroactive in adding value to prepetition claims, they might improve the value of the prepetition debt in order to induce DIP financing of an unprofitable project in a distressed firm (i.e., overinvestment) by the gain in the value of the prepetition debt. The DIP financing thereby causes a redistribution from unsecured creditors to the DIP lender, who can often capture most of these rents because of its privileged position as a lender with prebankruptcy exposure to the debtor.

Although the 11th Circuit Court of Appeals held that cross-collateralization is not within the equitable authority of the bankruptcy court under §364,[32] most other courts regard it as disfavored but permissible, particularly if the DIP shows that it is necessary to obtain credit. The influential courts in Delaware and the Southern District of New York have issued guidelines relating to the authorization of cross-collateralization and roll-ups which require conspicuous disclosure of the terms and the justification, and provide that, barring compelling circumstances, they should not be approved without notice and hearing.[33]

The concern about cross-collateralization and roll-ups is reflected also in legal scholarship and reform proposals. The ABI's Chapter 11 Commission expressed skepticism that cross-collateralization and roll-ups are needed for debtors to obtain postpetition credit and that they are not costly to existing claimants.[34] The Commission recommended that these provisions – as well as debtor's concessions as to the validity of prepetition liens – not be permitted in interim DIP financing orders. It also proposed that roll-ups be limited even in final orders to exceptional cases in which the debtor shows that the terms with roll-up are better than the alternative financing arrangements and that the roll-up loan is in the best interest of the estate. In its response to the Commission's Report, the Loan Syndication and Trading Association argued that these provisions 'help debtors preserve their going-concern value by offering nonmonetary inducements to lend. . . . Prohibiting such provisions would impede debtors from obtaining DIP financing, to the detriment of all stakeholders.'[35] Although this empirical premise is difficult to prove, the LSTA's argument would have been strengthened if it pointed to a market failure that would prevent debtors from offering their DIP lenders a sufficiently enticing return prospectively out of the value created by their investment, rather than through cross-collateralization, roll-ups or other protections of their prebankruptcy liens.

IV. CONTROL PROVISIONS IN DIP LOANS

Priority and interest rates are key features of debt, but increasing scholarly attention has been paid to other contract terms, particularly control rights. As in the controversies over priming liens, cross-collateralization and roll-ups, a fundamental issue is whether common control rights are needed to tackle the overinvestment problem of insolvent debtors. The concern about some control features is that they are both unnecessary and inefficient. As discussed above, there is a contrast between the way that debt priority is determined outside and inside bankruptcy. Priority is determined outside of bankruptcy predominantly by rules that implement a first-in-time, first-in-right principle; in bankruptcy, courts authorize priority under a standard that depends on the facts of each case. The courts are called upon to police the assignment of priority to new financing on a case-by-case basis. It is similarly useful to compare the control rights of debtholders outside and inside bankruptcy. Creditor control rights are created contractually outside of bankruptcy through combinations of covenants, events of default clauses, acceleration provisions and enforcement rights. The covenants are drafted to constrain the decision making discretion of the debtor – such as the ability to acquire or dispose of assets or to make distributions to shareholders – and to impose trip-wires for default – such as the violation of certain financial ratio tests or the instigation of significant civil or regulatory legal actions against the debtor. The violation of a covenant and an event of default gives the lender the right to accelerate, and the lender can credibly threaten enforcement in order to gain even more influence in the decisions of the debtor.

These control provisions and the associated monitoring activity of lenders together play an important role in corporate governance, that benefits investors by reducing agency costs.[36] They form an important complement to the governance rights of shareholders and other stakeholders. A lender's control rights are problematic when the debtor becomes financially distressed or insolvent, and the lender's interests turn sharply toward the distribution rather than the size of the pie. The filing of bankruptcy and the onset of the automatic stay replaces the prebankruptcy control rights with a different governance system that relies more heavily on judicial oversight. For example, the debtor must first obtain court approval, after notice and a hearing, before using or disposing of any asset outside the ordinary course of business.

DIP loans likewise contain covenants to protect the DIP lender's expected return from agency costs.[37] Since they are postpetition agreements, they typically provide that they are not subject to the stay. In fact, in the case of a DIP loan by a prepetition creditor, they also protect the existing credit exposure. Over the past couple of decades, DIP financing agreements have included more and tighter covenants and events of default to constrain the decisions of the debtor. Three-quarters contain specific line item budget limits, over half limit monthly or quarterly capital expenditures and over half set profitability targets such as minimum monthly EBITDA.[38] The DIP loans commonly require frequent reporting of financial numbers including cash flow forecasts and demand a continuing cash management system.

Although §364 does not explicitly instruct the court to approve the events of default (or the interest rate and fees), courts do scrutinize these terms, especially if they are out of the ordinary and give the lender undue influence over the course of the bankruptcy case.[39] Some types of debt covenants are the subject of controversy, largely along the same lines as the features of cross-collateralization, roll-up and anti-avoidance protection: namely, are they necessary to attract DIP financing of efficient projects, do they enable overinvestment, and do they inflict costs on existing creditors?

Bankruptcy courts are now faced with a category of covenants that confer advantages to DIP lenders who seek to acquire assets or controlling interests over the debtor enterprise through bankruptcy auctions or reorganization.[40] The acquirers are often private equity or hedge funds, and they tend to lend to debtors with weaker financial conditions than their pure lender counterparts.[41] The loan-to-own strategy grew in the 2000s[42] and was particularly pronounced during and in the aftermath of the financial crisis of 2008–09. Of the seventy-four private-equity-sponsored companies filing for bankruptcy in 2009, for instance, forty-three (58%) received DIP financing and, in 53% of that subset, the DIP lenders emerged as owners of the debtor or purchasers of its assets.[43] In a study of large bankruptcy cases between 2000 and 2013 in which the debtor was acquired by a fund, the purchaser was a prepetition stakeholder 54% of the time and a DIP lender at least 19% of the time.[44]

The Chapter 11 Commission expressed concern about milestones and deadlines that relate ‘in a material or significant way to the debtor's operations . . . or to the resolution of the case,’ such as setting deadlines for the holding of an auction, closing of a sale or proposing a plan and filing of a disclosure statement in connection with a plan. One study suggests that these covenants appear in almost a quarter of DIP financing agreements.[45] The Commission's concern was that these loan covenants accelerate asset sales and lead to loss of value that would have been realized through either reorganization or an extended sale process. While bank-provided DIP lending is correlated with emergence of a going concern from Chapter 11,[46] it appears that DIP lending by other institutions is associated with more asset sales. The Commission did not propose a ban on milestones and deadlines in DIP loan covenants but instead recommended (a) a prohibition on such provisions in interim orders and (b) a 60-day moratorium from the petition date on the effective date of such covenants.

V. CONCLUSION

New debt in bankruptcy is subject to a very different governance regime than debt issuance outside of bankruptcy, largely because of the debtor's insolvency. The rules that apply outside of bankruptcy are replaced by judicially applied standards that address the debt overhang problem without exacerbating the debtor's incentive to overinvest in risky projects with negative expected net present value. The assignment of priority is different: outside bankruptcy, it is largely a property-based, first-in-time rule or priority across liens, while a bankruptcy court can authorize later-in-time priority if necessary to resolve the debt overhang in the particular debtor. Outside of bankruptcy, parties enjoy greater freedom of contract: they can grant liens in a broad range of assets, cross-collateralize and roll-up debt if they choose to, and are free to include covenants and events of default that give control to lenders over the decisions of the debtor. Inside bankruptcy, this freedom in either contracting or enforcing is subject to judicial oversight because of the policy concern that the debtor-in-possession will not be a faithful agent of its principals in bankruptcy, namely its marginal creditors. How far the courts can or should go in their oversight is a matter of current debate, as described in this chapter. As the opposing sides in the policy debates examine DIP loan contracts on a term-by-term basis, the dispute largely boils down to two empirical questions. Is the contract term in question necessary to induce new lending and does it distort the efficient decisions of the debtor regarding asset deployment? One can anticipate two helpful developments in the next few years: first, further evolution in the market for DIP loans and second, more empirical insights derived from the availability of digital court records and dockets.

NOTES

1. Peter Tufano, *Business Failure, Judicial Innovation, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 Bus. Hist. Rev. 1 (1997); David A. Skeel, Jr., *The Past, Present, and Future of Debtor-in-Possession Financing*, 25 Cardozo L. Rev. 1905 (2004).
2. Under Bankruptcy Rule 4001(c)(2), the court may hold a hearing on motion to authorize credit no earlier than 14 days after service of the motion, but it may waive the notice and authorize the financing earlier only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.
3. Sandeep Dahiya, John Kose, Puri Manju & Gabriel Ramirez, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. Fin. Econ. 259 (2003) (finding an increase from 10.42% of their sample in 1989 to 48.2% in 1996); Siris Chatterjee, Upinder S. Dhillon and Gabriel G. Ramirez, Debtor-in-Possession Financing, 28 J. Bank. & Fin. 3097 (2004) (observing a similar growth from 27% in early 1990s to 46% in late 1990s).
4. Maria Carapeto, *Does Debtor-in-Possession Financing Add Value?* (October 28, 2004) (unpublished manuscript on file with the author); Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511 (2009); Lynn M. LoPucki & Joseph W. Doherty, Bankruptcy Survival, 62, UCLA L. Rev. 970 (2015); Stuart Gilson, Edith S. Hotchkiss & Matthew Osborn, *Cashing Out: The Rise of M&A in Bankruptcy* (August 15, 2015) (unpublished manuscript) http://ssrncom/abstract=2547168); Kai Li & Wei Wang.
5. George Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 Vand. L. Rev. 901 (1993); George Triantis, *A Free Cash-flow Theory of Secured Debt and*

Creditor Priorities, 80 Va. L. Rev. 2155 (1994); George Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. Legal Stud. 35 (2000).

6. Bank of Am. v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).
7. Dahiya, Kose, Manju & Ramirez, *supra* note 3; Carapeto, *supra* note 4; Stuart C. Gilson, *Coming Through in a Crisis, How Chapter 11 and the Debt Restructuring Industry are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012); Loan Syndications and Trading Assoc., The Trouble with Unneeded Bankruptcy Reform: The LSTA's Response to the ABI Chapter 11 Commission Report (2015); LoPucki and Doherty, *supra* note 4.
8. Comm'n to Study the Reform of Chapter 11, Am. Bankr. Inst., 2012–2014 Final Report and Recommendations (2014).
9. Triantis, George (1994), *supra* note 5; Triantis, George (2000), *supra* note 5.
10. Stuart C. Myers, *The Determinants of Corporate Borrowing*, 5 J. Fin. Econ. 147 (1977).
11. Rene M. Stulz & Herb Johnson, *An Analysis of Secured Debt*, 14 J. Fin. Econ. 501 (1985).
12. Triantis, George (1994), *supra* note 5; Triantis, George (2000), *supra* note 5.
13. Id.
14. Triantis, George (1994), *supra* note 5; Oliver Hart and John Moore, *Debt and Seniority: An Analysis of the Role of Hard Claims in Constraining Management*, 85 Am. Econ. Rev. 567 (1995).
15. Triantis, George (1994), *supra* note 5.
16. Triantis, George (1994), *supra* note 5; Triantis, George (2000), *supra* note 5.
17. Ayotte & Morrison, *supra* note 4 (finding a 35% drop in asset value and eleven-fold increase in secured debt during the year or two before bankruptcy); Jay L. Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. Ill. L. Rev. 831 (finding that the amount of secured debt exceeded the total scheduled asset value in 29% of the filed cases in 2006).
18. Barry Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J.L. Econ. & Org. 461 (2013); Gilson, Hotchkiss & Osborn, *supra* note 4.
19. Triantis, George (2000), *supra* note 5; Kenneth Ayotte and David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. Chi. L. Rev. 1557 (2013).
20. Triantis, George (2000), *supra* note 5.
21. The debtor applies for authorization to use cash collateral under Bankruptcy Code §363(c)(2) (in the ordinary course of business) or §363(b)(1) (outside the ordinary course). Debtors often apply for a preliminary order at the beginning of the case and the court may authorize the use of cash collateral on such an interim basis only if there is a reasonable likelihood that the debtor will prevail at the final hearing. Bankruptcy Code §363(c)(3).
22. The authorization of a lien in avoidance actions or proceeds therefrom is controversial and the Chapter 11 Commission proposed that it be discontinued. This chapter suggests that efficiency is most likely promoted when the collateral assets are those created as a result of the new financing. In contrast, avoidance actions are existing assets of the estate.
23. Empirical studies have found a range: for example, from 65% in the 2001 sample of Ayotte and Morrison, Ayotte & Morrison, *supra* note 4, to almost 90% in the 2009 sample of Coyne, Daniel J. Coyne, *Debtor-in-Possession Financing Agreements in Private Equity-Sponsored Companies in Bankruptcy* in 2009 (July 2012) (unpublished manuscript) (on file with author).
24. These effects of DIP financing priority on over- and under-investment are discussed in Triantis, George (1992). See Robert Gertner and David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. Fin. 1189 (1991).
25. A study published by Moody's confirms that the default risk of DIP lenders to large public companies has been low. Moody's examined the default and loss experience of facilities in its DIP database including 297 bankruptcy cases that were resolved, either through emergence or liquidation of the DIP. Of the 297 cases, only two DIP facilities

experienced defaults involving missed payments of scheduled principal or interest, suggesting a default probability of about 0.5%. William Fahy, Moody's Comments On Debtor-In-Possession Lending 4 (Oct. 2008), https://www.moodys.com/sites/products/DefaultResearch/2007300000539803.pdf.

26. Dahiya, Kose, Manju & Ramirez, *supra* note 3; Carapeto, *supra* note 4; LoPucki & Doherty, *supra* note 4 (finding no statistically significant difference in the key districts of Delaware and the SDNY).
27. The ABI Chapter 11 Commission Report noted that intercreditor agreements between junior and senior secured creditor groups often contain clauses that prohibit the junior secured creditors from offering DIP financing without the consent of the senior secured creditors. The Commission was concerned about the possible reduction in competition for credit and proposed to limit the enforcement of these agreements to provisions that prohibit the priming of the senior secured creditor and that gave the senior secured creditor the right to lend on the same terms offered by the junior lender and approved by the court. Am. Bankr. Inst., *supra* note 8.
28. Dahiya, Kose, Manju & Ramirez, *supra* note 3 (finding that the DIP lender is a prepetition secured lender in 58% of cases in their sample).
29. In fact, while priming liens are particularly common when the DIP lender is a prepetition creditor (or the lending syndicates overlap, the loans often prime the DIP lender's own prepetition lien. Dahiya, Kose, Manju & Ramirez, *supra* note 3; Ayotte & Morrison, *supra* note 4.
30. *See, e.g.*, Gilson, Hotchkiss & Osborn, *supra* note 4.
31. Another term having a similar distributional effect grants a lien to the new DIP lender on avoidance actions and proceeds therefrom. Bankruptcy Rule 4001(c)(1)(B)(xi). The ABI Chapter 11 Commission proposed that such DIP liens be banned. Am. Bankr. Inst., *supra* note 8.
32. *In re* Saybrook Mfg. Co., 963 F.2d 1490 (11th Cir. 1992); David A. Skeel, Jr., *The Story of Saybrook: Defining the Limits of Debtor-in-Possession Financing*, in R.K. Rasmussen, (ed.), Bankruptcy Law Stories (2007).
33. Del. L. Bankr. R. 4001-2(a)(i)(2002); S.D.N.Y. L. Bankr. R. 4001-2.
34. Am. Bankr. Inst., *supra* note 8, at 75–9.
35. Loan Syndications and Trading Assoc., *supra* note 7.
36. George Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Cal. L. Rev. 1073 (1995); George Triantis, *Debt Financing, Corporate Decision Making, and Security Design*, 26 Can. Bus. L. J. 93 (1995); Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. Fin. Econ. 117 (1979).
37. Chatterjee, Dhillon & Ramirez, *supra* note 3.
38. Ayotte & Morrison, *supra* note 4; Chatterjee, Dhillon & Ramirez, *supra* note 3.
39. The guidelines for approval of DIP financing motions in the Southern District of New York refers to these terms as extraordinary and requires that they be clearly disclosed. S.D.N.Y. L. Bankr. R. 4001–02.
40. Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Process*, 2005 Colum. Bus. L. Rev. 191 (2005); David A. Skeel, Jr., *Creditors' Ball: The 'New' New Corporate Governance in Chapter 11*, 152 Pa. L. Rev. 917 (2003); Skeel, *supra* note 1.
41. Li & Wang, *supra* note 4.
42. *Id.*
43. Coyne, *supra* note 23.
44. Michelle M. Harner et al., *Activist Investors, Distressed Companies and Value Uncertainty*, 22 Am. Bankr. Inst. L. Rev. 167 (2014).
45. Ayotte & Morrison, *supra* note 4.
46. Gilson, *supra* note 7.