THE PAST, PRESENT AND FUTURE OF DEBTOR-IN-POSSESSION FINANCING

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INTRODUCTION

There’s a new kid on the block in Chapter 11. Actually, the new kid—the debtor-in-possession (“DIP”) financiers who now figure prominently in many of the most high profile Chapter 11 cases—isn’t new at all. Chapter 11’s distinctive post-petition financing rules trace their ancestry back to the origins of large scale corporate reorganization in America in the nineteenth century. Corporate reorganization began with the common law “equity receiverships” that were used to reorganize America’s troubled railroads.¹ Almost from the beginning, courts promised special priority to lenders who would help finance reorganization efforts. Originally known as “receiver’s certificates,” these loans helped to keep the railroads going during the often lengthy restructuring process, much as DIP financing does today.²

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¹ The origins of large scale corporate reorganization in America are described in detail in DAVID A. SKEEL, JR., DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48-69 (2001).


(a) If the trustee is authorized to operate the business of the debtor under section 721, 1108, 1203, 1204, or 1304 of this title, unless the court orders otherwise, the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.

(b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.

(c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

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In this sense, post-petition financing has always been with us. But in the past decade, the role of the financiers has changed. After a century in the shadows, post-petition lenders have stepped onto center stage. The DIP loan agreement has become the single most important governance lever in many large Chapter 11 cases. After United Airlines filed for bankruptcy, the bank syndicate that provided its DIP financing pressured the company to obtain substantial wage concessions from its unions.\(^3\) FAO Schwarz’s lenders gave the posh toy company two months to reorganize or sell its assets, or the lenders would shut it down.\(^4\)

To be sure, DIP financing isn’t for every debtor. Even among publicly held debtors, roughly half do not obtain DIP financing in connection with their Chapter 11 case. But the percentage that do has steadily increased over the past decade,\(^5\) and there is no evidence that this trend will be reversing any time soon. Moreover, the largest and most prominent debtors are the ones that are most likely to look to a DIP financier for funds.

Why have these formerly bashful financiers suddenly started hogging the spotlight? I argue in this article that the generous terms offered to DIP financiers have encouraged lenders to make loans to cash-starved debtors, and that these lenders have used their leverage to fill a governance vacuum that was created by the enactment of the 1978 Code. Prior to the New Deal, J.P. Morgan and a handful of other Wall Street banks dominated the governance process when large companies were reorganized. The New Deal reformers kicked the Wall Street banks out in 1938, and required that a trustee be appointed to run the debtor’s business in large reorganization cases. When the 1978 Code eliminated the mandatory trustee requirement, it left a governance void

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\(^3\) See generally Marilyn Adams, *Low-Cost Carrier Plan Trips Up UAL*, USA TODAY, Mar. 14, 2003, at B3 (noting United’s plan to ask for rejection of union contracts because it “needs those savings to meet cash-flow targets set by lenders”).


in Chapter 11. After creditors were burned in a number of post-1978 cases, bank lenders began using their post-petition financing agreements to rein in debtors' managers, and to influence the course of the reorganization process.

After recounting this history in Part I of the Article, I describe the current DIP financing arrangements in Part II. There are two general kinds of DIP loans. In most cases, the DIP financing takes the form of a standard loan. By structuring the loan as a revolving credit agreement, and imposing strict conditions on each new round of financing, the lender is assured that it will have significant leverage over the debtor's managers' decision-making throughout the Chapter 11 process. I call these arrangements "loan-oriented" DIP financing. I refer to the second type of DIP financing arrangement as "loan-and-control" financing. In these cases, the DIP loan is used to transfer control to the DIP lender itself, either through a sale to the DIP lender or as the intended outcome of the Chapter 11 reorganization.

Although DIP lenders have improved Chapter 11 governance in the past decade, there are significant grounds for concern as well. I explore these concerns in Part III. With loan-oriented DIP financing, the principal concerns are that the lender may have too great an incentive to force the debtor to liquidate assets, due to the lender's priority status; and that the lender will use the post-petition loan to improve the status of loans it extended prior to bankruptcy. The principal danger with loan-and-control transactions is that the DIP financing arrangement will divert value from general creditors or stymie other competing bids for control of the troubled company.

I offer a variety of proposals for counteracting these problems. Courts should refuse to permit provisions that protect a pre-petition loan, for instance; better yet, the pre-petition and post-petition loans should be separated, and the pre-petition portion paid last. With loan-and-control transactions, I argue that provisions that could chill alternative bids should be subject to at least as much scrutiny as anti-takeover Devices receive outside of bankruptcy. I also argue that claims trading is often a superior mechanism for transferring control, and should be encouraged by reducing some of the frictions that interfere with the market.

If Part I explores post-petition financing's past, and Part II focuses on the present, the proposals outlined in Part III can be seen as my hope for the future. The future of debtor-in-possession financing isn't limited to Chapter 11, however; other jurisdictions have adopted similar provisions, or are considering doing so. Part IV concludes the Article by very briefly describing some of the implications of the analysis for other jurisdictions.
I. THE PAST: FROM RECEIVER'S CERTIFICATES TO DIP FINANCING

Like just about everything in U.S. corporate reorganization, debtor-in-possession financing can be traced back to seeds that were first planted in the era of the nineteenth-century railroad receiverships. In the discussion that follows, I begin by briefly describing the railroad receivership process that eventually led to Chapter 11, then turn to the financial innovations that paved the way for debtor-in-possession financing.6

A. Equity Receiverships and the Origins of DIP Financing

The classic equity receiverships involved moderately large railroads—railroads whose tracks crossed several state lines, and which had issued common stock, preferred stock, and several different mortgage bonds to raise money over the years. If the railroad encountered financial distress, and failed to make the requisite interest payments on its bonds, a creditor would first file a “creditor’s bill” asking the court to appoint a receiver to oversee the defaulting railroad’s property. The principal reason for appointing a receiver was that doing so technically shifted control of the railroad’s assets to the receiver and out of the reach of prying creditors. If a creditor tried to obtain a lien against railroad property, for instance, the receiver would simply ask the court for an injunction.

The next step was to file a second “bill,” the foreclosure bill. In form, the foreclosure bill asked the court to schedule a sale of the property (and solemnly invoked the liquidation-oriented language of traditional foreclosure law). In reality, the sale would be put off for months, and often years, while the parties negotiated over the terms of a reorganization plan.

In the meantime, the investment banks that had underwritten the railroad’s bonds would quickly form a bondholders’ committee to represent bondholders in the negotiations. If the firm had issued more than one class of bonds, several committees might form; and there might also be committees of common stockholders and preferred stockholders. The virtue of forming a committee was that it centralized the bargaining process, and theoretically gave thousands of widely scattered bondholders a champion—which, in large receiverships at the turn of the century, usually meant J.P. Morgan and Company, Kuhn,

6 The initial discussion of equity receiverships is drawn in part from SKEEL, supra note 1, at 58-59.
Loeb, or one of a small group of other Wall Street banks.

To ensure their authority, the committee representatives asked, investors to "deposit" their bonds (or stock, for a stockholders committee) with the committee. By depositing their bonds, investors gave the committee complete control over the bonds for the duration of the negotiations, with one limitation: bondholders would have the right to withdraw their bonds if they disapproved of the plan that the committee negotiated on their behalf.

The goal of the negotiations was to rework the railroad's capital structure, reducing its obligations so that it could get back on track financially after the receivership. Often this meant converting fixed obligations into variable ones, or reducing interest rates, or extending the payback period.\(^7\) Once they had agreed to an overall plan, the committees were combined to form a single super-committee called the "Reorganization Committee." It was the Reorganization Committee that "purchased" the railroad's assets at the foreclosure "sale." Since the Reorganization Committee had all of the deposited securities at its disposal, and could bid the face value of the securities as a substitute for cash, no one else bothered to bid at the auction. In the words of Paul Cravath, one of the leading receivership lawyers: "[c]ounsel who have acted frequently for reorganization committees have spent a great many anxious hours preparing for the unexpected bidder, but in my own experience he has never appeared. . . . Manifestly in most sales where the security holders . . . have . . . placed their interest in the hands of a committee there is not likely to be serious competition at the sale."\(^8\)

As soon as the Reorganization Committee purchased the assets, it transferred them to a shell corporation that had been set up for just this purpose. The stock and other securities of the new corporation were then distributed to the old investors on the terms laid out in the reorganization plan.

The dry recitation of facts that have I have just given doesn't even begin to convey the ingenuity of the receivership process. The biggest marvel of all was where it came from: in form, the equity receivership was a dramatic elaboration of the traditional foreclosure procedure, the humble device that had been used for generations, and is, of course, still

\(^7\) For a description of the adjustments made in one typical receivership, see Peter Tufano, Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century, 71 Bus. Hist. Rev. 1, 15 (1997). In a fascinating recent analysis of the railroad receiverships, Stephen Lubben argues that the reorganizers tried to give the reorganized company a capital structure that was typical for the industry, rather than aiming for an optimal structure, and as a result often did not scale down the railroad's obligations enough. Stephen J. Lubben, Railroad Receiverships and Modern Bankruptcy Theory 67 (Dec. 3, 2003) (unpublished manuscript).

\(^8\) Paul D. Cravath, Reorganization of Corporations: Certain Developments of the Last Decade, in SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION 153, 204-05 (1922).
used by secured creditors to force a sale of the debtor's collateral after the debtor has defaulted on his or her obligations. The development of the equity receivership was one of the great innovations of the common law in nineteenth-century America.9

The procedures I have described didn't end the adaptive process. An important problem both before and during the receivership was that the railroad needed to pay its suppliers—the company that provided coal to fire the engines, the supplier of iron or steel—in order to keep the railroad running. The question was how. Troubled railroads generally didn't have a great deal of cash on hand, and the limited cash they had was needed to make payments on their mortgage bonds and other priority debt. But suppliers were reluctant to deal with the railroad on credit if it looked like there might be a receivership on the horizon, since the supplier's right to payment was subordinate to the rights of creditors who had mortgages on the railroad's assets.10 This meant that a supplier who sold goods on credit might end up helping out the higher priority creditors—who were more likely to get paid if the railroad kept going—while the supplier itself, as an ordinary unsecured creditor, got paid only a portion of what it was owed. Not surprisingly, railroad suppliers weren't especially enthusiastic about extending credit for the benefit of other creditors.

The courts lent a helping hand to railroad debtors by developing a doctrine known as the "six months" rule. The six months rule, which was endorsed by the Supreme Court in 1876,11 permitted the debtor to pay suppliers in full, rather than treating them like other non-priority creditors, for supplies that were provided within six months of the initiation of a receivership. Courts assumed that the railroad's priority creditors would be happy for the suppliers to get paid, since suppliers might cut the railroad off at the first sign of financial distress if they weren't sure about repayment in the event of a receivership. "Every railroad mortgagee in accepting his security," the Supreme Court concluded, "impliedly agrees that the current debts made in the ordinary course of business shall be paid from the current receipts before he has any claim upon the income."12 In its initial incarnation, the six month rule applied to wages, supplies and essential services. It was later

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9 I do not mean to suggest that receiverships were perfect. Critics complained about the fees charged by the Wall Street banks and lawyers who spear-headed them, and to some extent about the efficacy of the process itself. For evidence that many of the railroads that failed later defaulted again, see Lubben, supra note 7.

10 This problem is referred to in the corporate finance literature as an "underinvestment" or "debt overhang" problem. Lenders will refuse to lend even for desirable projects if the proceeds of the project will be soaked up by existing creditors. For discussion in the receivership context, see Tufano, supra note 7, at 7-9.


12 Id. at 252.
expanded to include key trade creditors under the "doctrine of necessity," "so long as the claimant is in position to demand payment as the price of future labor and materials."\textsuperscript{13} (Over a century later, the necessity doctrine continues to be applied in something like its early form, although its validity has recently been called into question by a high profile case.\textsuperscript{14})

By itself, the six months rule solved only part of the problem; there was also the rather important question of where the cash would come from. This is where a second innovation came in. To help troubled railroads raise money during the receivership process, courts authorized the receiver to issue a "receiver’s certificate." It was the receiver’s certificate that eventually gave rise to debtor-in-possession financing as we know it today.

A receiver’s certificate was a promissory note issued by the receiver, "by which the railroad borrowed from investors against the credit of the ‘whole estate’ of the railroad” on a short term basis.\textsuperscript{15} The beauty of the certificates, at least from the receiver’s perspective, was that they were given priority over all of the railroad’s other obligations—even over existing mortgages. Mortgage payments weren’t made until the receiver’s certificate obligations were taken care of first, and the holders of receiver’s certificates were also entitled to first dibs on the proceeds of any sale of the property that secured the certificates. (The explanation for the superpriority of receiver’s certificates was that they were an obligation of the receivership, rather than of the debtor, and creditors of the debtor were entitled to payment only from the assets of the railroad, net of receivership expenses.) Given the high probability of repayment, investors were happy to help finance the receivership by investing in receiver’s certificates.

The description of one series of receiver’s certificates in \textit{Union Trust Co. v. Illinois Midland Railroad Co.}\textsuperscript{16} gives the flavor of some of the expenses that were financed by the certificates. "There are four certificates of the eighteenth series," the Court noted,

three of them for $10,000 each, and one for $8,288.98, all at 8 per cent. interest, issued under another order made June 29, 1881, which set forth that the receiver had expended on the Illinois Midland road,

\textsuperscript{13} Benjamin Wham, \textit{Preference in Railroad Receiverships}, 23 Ill. L. Rev. 141, 147 (1928), quoted in Lubben, supra note 7, at 39 n. 128.

\textsuperscript{14} The Seventh Circuit ruled in the Kmart bankruptcy that, because there was no finding that Kmart’s disfavored creditors would be better off, the necessity doctrine did not justify the extensive payments to prepetition creditors that the bankruptcy court had approved in that case. Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 823 (N.D. Ill. 2003), rev’d, 2003 U.S. Dist. LEXIS 17437, aff’d, 2004 U.S. App. LEXIS 3397 (7th Cir. 1991).

\textsuperscript{15} Tufano, supra note 7, at 8. The contours of receiver’s certificate doctrine were treated in exhaustive detail in an early monograph. See William A. Car, \textit{Receiver’s Certificates}, 1 Pa. L. Series 595 (1895).

\textsuperscript{16} 117 U.S. 434 (1886).
for side tracks and other betterments, $80,037.98, of which $42,664.98 had been expended on the line between Paris and Decatur; that, of the $80,037.98, $63,037.98 had been paid out of the earnings of the line, of which $38,288.98 was expended on the line between Paris & Decatur; that the earnings of the whole line had not be sufficient to meet the usual expenses of operation and the ordinary repairs of the permanent way; and that the receiver had incurred unpaid debts to a larger amount than $63,097.38, in the usual operation of the line and in ordinary repairs of the permanent way.\textsuperscript{17}

Under the practice that developed, the receiver would identify the immediate cash needs of the railroad and ask the court to authorize him to issue receiver's certificates. Often the certificates were issued for projected expenses, but sometimes (as in the \textit{Union Trust} description above) the receiver requested funding for expenses that had already been incurred.

Over time, the use of receiver's certificates gradually expanded. The earliest receiver's certificates were premised on the belief that there was a public interest in preserving troubled railroads, and were issued for the limited purpose of maintaining tangible collateral.\textsuperscript{18} Within a few years, courts had begun authorizing certificates for the costs of operating the railroad, even where these costs didn't relate directly to protecting tangible collateral. If the situation was hopeless, courts sometimes rejected a receiver's request to sell certificates, but they were generally permitted, despite the interference with existing mortgages. "So far as such an impairment is necessary to the conservation of the road," the Sixth Circuit wrote in a prominent opinion, "and the performance of its public and private duties, [mortgage holders] must submit to the impairment ... but [they] should not ... suffer ... further than actually necessary for conservation and due operation of the system."\textsuperscript{19}

By the end of the nineteenth century and the outset of the twentieth, an increasing number of non-railroads had begun to use the receivership process to restructure. Because the public interest in preserving non-railroads was less obvious, the courts were much tougher about authorizing receiver's certificates in non-railroad receiverships. If financing was needed to preserve corporate assets (a category that was construed broadly enough to include insurance premiums and wages for watchmen), courts would generally permit the receiver to sell priority certificates. But expenses that arose from

\textsuperscript{17} Id. at 453.

\textsuperscript{18} For a useful overview of the developments described in this paragraph, see Harvey J. Baker, \textit{Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals}, 50 AM. BANKR. L.J. 1, 8-16 (1976).

\textsuperscript{19} American Brake Shoe & Foundry Co. v. Pere Marquette R. Co., 205 F. 14 (6th Cir. 1913), cert. denied, 229 U.S. 624 (1913), quoted in Baker, supra note 18, at 10.
ordinary operations were treated as out of bounds. The line between “preservation” and “operations” was blurry, of course, and receivers stuffed everything they could into the “preservation” category, but the receiver’s certificates had a notably narrower scope outside of the railroad context.\footnote{See Baker, supra note 18, at 16; Lyman M. Tondel, Jr. & Robert H. Scott, Jr., Trustee Certificates in Reorganization Proceedings Under the Bankruptcy Act, 27 Bus. L. 21, 31-32 (1971).}

B. DIP Financing as a Governance Device

As the discussion thus far suggests, receiver’s certificates were a crucial source of short term financing for railroads and other corporations that were reorganizing under the equity receivership process. What we don’t see when we revisit the receivership era, however, is the holders of receiver’s certificates playing a central oversight role. No one would describe these investors as dictating, or even influencing, the governance of the debtor.

The obvious question is, what happened? How did DIP financing agreements become the most important governance lever in contemporary corporate reorganization cases?

The answer lies in two historical developments. The first was the transformation of traditional large scale reorganization during the New Deal. The magicians of the reorganization process, as we saw in the last section, were the Wall Street banks and lawyers who formed bondholder and shareholder committees, then hashed out the terms of the restructuring with the debtor’s managers.\footnote{See supra note 7 and accompanying text.} The New Deal reformers were deeply suspicious of the Wall Street reorganizers’ handling of the receivership process, which seemed designed to maximize the professionals’ fees rather than to protect investors. “Managements and bankers,” they concluded in an extensive SEC study overseen by William Douglas, a Yale law professor who later became chair of the SEC and then a Supreme Court Justice, “seek perpetuation of [their] control for the business patronage it commands, which they take for themselves or allot to others, as they will.”\footnote{SKEEL, supra note 1, at 111.}

The reformers’ solution to the traditional receivership process was Chapter X, a new set of large scale corporate reorganization provisions that Douglas and the New Deal SEC inserted into an extensive overhaul of the bankruptcy laws that was enacted in 1938.\footnote{See id. at 109-27 (discussing the reforms, and Douglas’s role in detail).} Chapter X required that the managers of a corporate debtor be replaced by a trustee after the
firm filed for bankruptcy. It was the court-appointed trustee, rather than the existing managers, who would run the business and develop the terms of a reorganization plan, and the plans were subject to close scrutiny by the SEC. Chapter X also introduced tough new disinterestedness requirements that prohibited bankers or lawyers who had represented the debtor prior to bankruptcy from participating in the bankruptcy case.

Chapter X’s mandatory trustee and disinterestedness provisions thrust a dagger in the heart of large scale corporate reorganization practice as the reorganizers had known it. In a traditional receivership, the existing managers remained in place, and the same Wall Street professionals who had underwritten the debtor’s securities before the receivership also oversaw the restructuring negotiations. After 1938, none of these parties was permitted to show its face in a Chapter X case. The new provisions had precisely the effect the New Deal reformers had intended: they destroyed the traditional, Wall Street reorganization process. Within a few years the Wall Street banks and bar were gone.

Of particular importance for our purposes, this disappearance dramatically altered the governance of large scale reorganization cases. In Chapter X cases, the trustee and SEC oversight took the place that had previously been occupied by the Wall Street banks and bar. But by the 1960s, many large corporate debtors had begun filing their cases in Chapter XI, the chapter that was intended for small firms. In Chapter XI, neither the trustee nor the SEC was anywhere to be seen. When current Chapter 11 was enacted in 1978, the drafters adopted a presumption that managers rather than a trustee would run the company in bankruptcy and largely eliminated the role of the SEC, thus taking their cue from Chapter XI—the oversight-free zone—rather than Chapter X.

The second crucial development was the continuing expansion of the scope of receiver’s certificates. As described in the last section, the use of receiver’s certificates was initially linked to the public interest in reorganizing troubled railroads, and the proceeds were used both to preserve the value of the railroad’s assets, and to finance operations during the receivership process. Courts later permitted receivers to sell

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25 See id. § 172 (reorganization plan in any case over three million dollars required to be submitted to the SEC for comments).
26 See id. §§ 157, 158 (bank underwriter disinterestedness).
27 For further discussion of the demise of the Wall Street reorganization practice, see Skeel, supra note 1, at 125-27.
28 See id. at 161-81 (recounting the increasing use of Chapter XI, and the eventual repudiation of the Chapter X approach to large scale reorganization).
the certificates in reorganizations that did not involve a "public interest," but were more restrictive about the scope of the certificates.

Until the 1930s, corporate reorganization—and thus the use of receiver's certificates—was a creature of the common law. Receivership practice was first added to the bankruptcy laws in the early 1930s with the codification of railroad receivership in 1933 and of non-railroad reorganization the following year. The new statutes explicitly authorized the issuance of receiver's certificates for short term financing. The provision that made its way into Chapter X of the Chandler Act in 1938 stated, for instance, that:

[T]he court may upon cause shown authorize a receiver, trustee, or debtor in possession, . . . to issue certificates of indebtedness for cash, property, or other consideration approved by the judge, upon such terms and conditions and with such security and priority in payment over existing obligations, . . . as in the particular case may be equitable.

The most noteworthy aspect of this rather vague provision is that it does not include any reference to the distinction between "preservation" and "operation." The absence of this qualification even in non-railroad cases seems, as a later commentator noted, to have "rendered that distinction obsolete," and thus to have further expanded the scope of this financing technique. After the 1930s, it was clear that receiver's certificates could be used to finance the ordinary operations of any corporate debtor, regardless of whether the debtor's business was quasi-public in nature.

The enactment of the 1978 Bankruptcy Code brought the most dramatic expansion of all. Not only did the last vestiges of the distinction between quasi-public and private businesses fall by the wayside, but the drafters removed any expectation that the financing be tied to specific expenditures. Section 364, which governs debtor-in-possession financing, is a broad-based source of authority for all kinds of post-petition credit. Under § 364, the debtor can borrow on an unsecured basis, with the promise of administrative expense treatment

\[30\] Railroad receivership was added to the Bankruptcy Act as Section 77, and non-railroads were included in an analogous set of provisions known as Section 77B. The non-railroad provisions were replaced by Chapter X in 1938. For discussion, see, for example, SKEEL, supra note 1, at 105-09; Charles Jordan Tabb, The History of the Bankruptcy Laws in the United States, 3 AM. BANKR. INST. L. REV. 5, 28-30 (1995).


\[32\] Baker, supra note 18, at 17 n.68.

\[33\] Consistent with this breadth, § 364 is entitled simply "obtaining credit." The leading bankruptcy treatise characterizes § 364 as "derived from provisions in current law governing certificates of indebtedness, but [as] much broader. It governs all obtaining credit and incurring of debt by the estate." COLLIERTON BANKRUPTCY APP. Pt. 4(d)(i), at 1480 (15th ed. 2003) (1996) (volume covering legislative history).
for the lender, without first seeking court approval. If unsecured financing is unlikely to be available, the court can give the DIP financer priority over all other administrative expenses; or authorize a lien on either unencumbered or already encumbered property. The court’s most dramatic power is the right to authorize a new “priming” lien that has priority over an existing lien on the same property.

With the advent of § 364, bankruptcy financing looked very different from the carefully tailored receiver’s certificates that courts had authorized in the late nineteenth century. It wasn’t simply a stopgap anymore.

II. PRESENT: THE NEW CONTOURS OF DIP FINANCING

The developments just described set the stage for the process we see today, with DIP lenders dictating the course of many large reorganization cases. But the transformation was not immediate. For the first decade after the enactment of the 1978 Bankruptcy Code, the debtor and its managers seemed to control the course of many large scale Chapter 11 cases. They were the only ones who could propose a reorganization plan for at least the first 120 days of the case, and they also controlled the company’s ordinary operations and had the right to propose extraordinary transactions such as major asset sales. The debtor’s managers could use this agenda control to drag out the case, extract concessions from its creditors, or both.

In the mid and late 1990s, DIP lenders started using the terms of the debtor’s post-petition financing arrangements to counteract this hegemony, and to fill the governance vacuum. DIP financing and DIP lender monitoring didn’t begin in the 1990s. But since this time, it has become the most important governance lever in many large Chapter 11 cases. In this part, I briefly describe the contours of current DIP financing arrangements. I then describe the increasing use of DIP financing agreements to transfer control to the DIP financer.

34 Bankruptcy Code § 364(a).
35 Id. § 364(b) & (c).
36 Id. § 364(d).
37 I have described these developments in detail in David A. Skeel, Jr., Creditors’ Ball: The “New” New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 917 (2003), describing the increasing use of DIP financing arrangements and performance-based managerial pay as governance levers.

For an argument suggesting that DIP lenders have not exerted as much control as I and other commentators have argued, see Stephen J. Lubben, The Illusion of Control Rights—A Comment on the “New Chapter 11” (Dec. 6, 2003) (unpublished manuscript).
A. Loan-Oriented DIP Financing Arrangements

By the time a corporate debtor files for bankruptcy, its DIP financing arrangement is usually securely in place, awaiting only the initial approval of a bankruptcy court in connection with the debtor’s so-called first day orders. To understand the contours of DIP financing, we must therefore go back to the period before the debtor actually shows up at the bankruptcy court to file a bankruptcy petition.

When a company’s fortunes start spiraling downward, the decline often triggers a default under an existing loan agreement with the company’s bank lenders; or if there is no existing bank loan, forces the company’s managers to obtain one in order to meet its cash flow needs. The bank (or more often, syndicate of banks) usually insists that the company make significant changes. This increasingly means bringing in a chief restructuring officer (“CRO”) to work with the board of directors to develop a plan for getting the company back on its feet. The banks may influence the choice of CRO in a variety of ways, such as providing a short list of acceptable candidates or, at the least, giving a thumbs up or thumbs down to the person proposed by the debtor’s managers.38

If the debtor’s financing isn’t already structured as a revolving loan, this is the form it will take after the parties have negotiated the terms of continued financing.39 In a revolving loan, the amounts borrowed by the debtor come due on a regular, relatively short-term basis, such as every eighteen months or two years. If the banks are satisfied that the debtor is in compliance with the terms of the loan at that point, they will roll the loan over for another term and continue to make disbursements. During the interim, moreover, the debtor is generally required to meet strict cash flow targets.

If the debtor’s financial condition is sufficiently dire, the parties’ immediate plans may include bankruptcy. In this case, the debtor’s managers will seek court approval for the restructuring loan under § 364 as soon as the debtor files for bankruptcy. Even if the parties do not plan for bankruptcy at the outset, bankruptcy will soon be on the horizon if there are any glitches in the restructuring.

As the analysis thus far suggests, the most likely source of debtor-in-possession financing is the company’s existing lenders. Almost sixty

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39 For a similar point, see Douglas G. Baird & Robert K. Rasmussen, The End of Bankruptcy, 55 STAN. L. REV. 751, 784 (2003), stating that “[i]n the typical case, there is a revolving credit facility put in place when financial distress appears on the horizon.”
percent of the time, some or all of the company’s existing lenders also provide its post-petition financing. They are the lenders that know the debtor’s finances best. But a substantial minority of the time, the debtor ends up looking elsewhere. Because § 364 offers so much protection for lenders who provide post-petition financing, there is an active and still growing market for DIP financing.

Whoever the financing comes from—whether it be a familiar face or someone new—the debtor’s managers almost always line up the financing before they actually file for bankruptcy. Entering Chapter 11 without financing in place is a recipe for trouble. Debtors that go this route often face an immediate cash crunch and their managers will waste valuable time at the outset of the case as they try to secure financing.

How exactly, do DIP lenders use the post-petition financing arrangements to dictate the course of a Chapter 11 case? We have already seen one aspect of lender control: influence over managerial personnel. If the lenders believe that the company needs new management to oversee the restructuring process, they will insist on a change at the outset of the loan. When there is management turnover shortly before a company files for bankruptcy, this is often because the lenders have been pulling their strings.

Equally important is the use of affirmative and negative covenants in the loan agreement itself. The starkest strategy is to include one or more affirmative covenants with explicit drop dead dates. When FAO Schwarz filed for bankruptcy in 2002 (for what turned out to be the first of two filings), one of the covenants authorized the lenders to insist that the toy chain be liquidated unless it either sold all of its assets or confirmed a reorganization plan by April 4, 2002. In effect, the loan agreement served as a guillotine, giving the debtor’s managers one limited chance to restructure the company.

A slightly more subtle approach is to use affirmative covenants to keep the debtor on a tight leash, rather than imposing an explicit time-line for emerging from bankruptcy. In the United Airlines case, for instance, the DIP loan agreement required the airline to meet strict cash flow requirements as a condition of keeping the financing in place. Although the lending agreement didn’t explicitly require United to layoff workers and renegotiate its collective bargaining agreement, the lenders and the debtor’s managers were well aware that the only way United could satisfy the cash flow provision was by cutting its labor

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40 See, e.g., Dahiya et al., supra note 5, at 265 (finding that fifty-eight percent of DIP financiers were pre-petition lenders).
41 See supra note 38 and accompanying text.
42 See supra note 4 and accompanying text.
costs.\footnote{See generally Susan Carey, UAL Will Lay Off 1,500 Workers As Part of Cost-Cutting Strategy, WALL ST. J., Jan. 6, 2003, at A3 ("UAL Corp. said it intends to shed 14% of its management and salaried employees by Jun. 19, part of its plan to lower expenses to meet the strict terms of its debtor-in-possession financing package."); Adams, supra note 3, at 3B ("UAL is scheduled to ask the bankruptcy court as soon as Monday to let it break all its labor contracts to get billions of dollars a year in reduced labor costs. The airlines need those savings by May 1 to meet cash-flow targets set by lenders.").}

In a number of other recent cases, lenders have used their control over the cash spigot to force what bankruptcy lawyers refer to as a "slow liquidation." In these cases, the lenders reduce the amount of cash they make available in succeeding disbursements, which forces the company to sell assets in order to meet its cash flow needs. Over time, the company finds itself liquidating an increasing number of significant assets, and what began as an effort to reorganize under Chapter 11 becomes a prolonged asset sale.

The negative covenants in the loan agreement further reinforce the DIP lenders’ control. "In 90% of the cases," according to one recent study, "DIP loans have restrictions on specified operating expenses and operating activities." (By way of comparison, only six percent of junk bonds and sixty-seven percent of ordinary bank loans include comparable restrictions.\footnote{See Chatterjee et al., Debtor-in-Possession Financing 9 (May 31, 2001) (unpublished manuscript).})

It is important to note that many corporate debtors file for Chapter 11 and do not ever arrange for DIP financing, either before or after they file. The authors of a study of publicly held companies that filed for bankruptcy between January 1, 1988 and December 31, 1997 found, for instance, that slightly less than thirty-one percent of these debtors obtained DIP financing.\footnote{See Dahitya et al., supra note 5, at 266.} The percentage of cases with DIP financing had risen sharply by the end of the study—to nearly fifty percent—but this still means that there is no DIP financing in half of all large Chapter 11 cases.

In the cases that do involve DIP financing—which tend to be the largest and most viable debtors—DIP financing is superficially similar to the receiver’s certificates from which it evolved. The financing is short-term in nature—the median loan is 1.5 years—and the proceeds are used primarily to maintain operations during the Chapter 11 case. But rather than serving simply as a source of stop-gap funding, the DIP financing agreement is now the most important corporate governance lever in these cases.
B. DIP Financing and the Market for Corporate Control

In a recent speech before several hundred investors in distressed debt, Harvey Miller, who was the nation’s most prominent bankruptcy lawyer for several decades before joining the investment bank Greenhill and Company, bemoaned the current state of Chapter 11 practice. Current cases are little more than asset sales and auctions he complained; the days of traditional negotiated reorganizations are behind us.

While Miller may have exaggerated the extent of the changes to the Chapter 11 landscape, there is no question that bankruptcy practice has changed. Bankruptcy cases are dominated by merger and acquisition activities, as Miller notes, and lengthy backroom negotiations play less and less of a role. The use of DIP financing agreements as a governance lever isn’t the only development that has contributed to this trend. The value of New Economy assets deteriorates quickly, for instance, and markets for assets are much more fully developed than in the past, both of which may make asset sales a better way to maximize value than a negotiated restructuring. But DIP financing has also figured prominently in the increase of M&A practice in bankruptcy.

The DIP financing strategies we saw in the last section, such as metering the debtor’s access to cash, have increased the pressure on debtor’s managers to sell assets during the pendency of the Chapter 11 case. This section briefly describes how DIP financing agreements have been used to effect auctions and other transfers of control.

Two recent cases illustrate the range of loan-and-control transactions. In U.S. Air, the DIP lender, the Retirement Systems of Alabama, agreed to provide $240 million of initial financing and $500 million thereafter. In return, the Alabama pension was promised five of the thirteen seats on U.S. Air’s board of directors, together with 37.5% of the stock, when U.S. Air emerged from bankruptcy. Once the DIP

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47 See, e.g., Skeel, supra note 37, at 925-26; Baird & Rasmussen, supra note 39.

48 The governance terms were later renegotiated to give the Alabama pension an additional two seats on the board and to slightly reduce its ownership interest. See, e.g., Micheline Maynard, U.S. Air’s Chief Lender Threatens the Ultimate, N.Y. TIMES, Dec. 7, 2002, at C1 (describing the terms of the DIP financing, which were chosen by U.S. Air over a competing offer.
financing agreement was in place, the pension’s control over U.S. Air’s access to cash enabled David Bonner, the financer’s chief executive, to dictate the course of the reorganization case.49

In the U.S. Air bankruptcy, the change in control was effected by dictating the terms of the airline’s reorganization plan. A similar result can also be achieved through an asset sale that is arranged or dictated prior to bankruptcy. When TWA filed for bankruptcy for the last time, for instance, American Airlines provided financing under a DIP loan agreement that required an auction of TWA’s assets with American as the expected buyer.50 As with U.S. Air, the buyer effectively was determined before the debtor ever filed for bankruptcy. The principal purpose of the bankruptcy in TWA, as with many asset sales, was to ensure that American could purchase the assets free and clear of any existing or future claims, and to eliminate the claims of TWA’s unsecured creditors.

In each of these cases, the DIP lender was doing much more than simply providing financing. The loan agreement doubled as a mechanism for transferring control, usually to the DIP lender itself.

III. THE FUTURE? A CLOSER LOOK AT POTENTIAL MISUSES OF DIP FINANCING

The evolution of DIP financing vividly illustrates how private market actors adapt to their regulatory environment. In the beginning, it was called a receiver’s certificate and was used to fund a corporate debtor’s immediate cash needs. A century later, the DIP financing agreement has become the principal governance device in many Chapter 11 cases.

The emergence of DIP financing agreements as the principal governance lever in many current Chapter 11 cases has been, on the whole, a good thing. Chapter 11 put a great deal of decision making authority in the hands of the debtor’s managers, and left a governance vacuum. Active governance by DIP financiers has filled the void and counteracted the managers’ agenda control.

But there are also reasons for concern. This part explores the dark side of each of the types of DIP financing arrangements discussed in

49 See id. (describing Bonner’s threat to force a Chapter 7 liquidation unless U.S. Air obtained concessions from its employees).
Part II, and suggests ways to control the problems they pose. I begin, however, by considering the incentives of the managers who negotiate a firm’s DIP financing package. Because the managers face an endgame situation, their interests may diverge from the best interests of the corporation. It is this conflict that makes the other problems possible.

A. Managerial Incentives on the Eve of Bankruptcy

When the managers negotiate the terms of a DIP financing agreement, they establish the allocation of control rights that often will—if the court approves the agreement—govern the Chapter 11 case. If we could say with confidence that what’s best for the debtor’s managers on the eve of bankruptcy is also best for the corporation, there would be little reason to worry about DIP financing. Unfortunately, managers’ interests will often be in sharp conflict with the interests of the corporation when the firm is teetering on the brink.

Put yourself in the shoes of the company’s CEO. Perhaps the company is an upscale retail chain like the toy store FAO Schwarz whose future had looked quite promising only a few years before. The company’s flagship New York store featured prominently in a popular movie, and well-heeled parents roamed the aisles with their wide-eyed children. But the company stumbled as it tried to assimilate several smaller retail chains it had acquired. To make matters worse, a large, ruthlessly efficient discounter—say, Walmart—started offering some of the same luxury items at much lower prices. As the company runs out of cash, it opens negotiations with its lenders for debtor-in-possession financing and prepares to file for bankruptcy.

How is the CEO likely to view the negotiations? One possibility is that she remains convinced that the chain can regain its earlier luster, and that she is the one who will lead it back to glory. If this is the case, there is a danger that she will do whatever it takes to give herself and the company one more chance. If the lenders agree to let the CEO stay in charge, she may cede too much power to the company’s lenders, or agree to provisions that divert value from other creditors.

Alternatively, this may be the end of the line. As noted earlier, the

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51 For a brief overview of FAO’s decline, see, for example, Hays, supra note 4, at C10.
52 The incentive to focus on the manager’s own interests rather than the best interests of the firm is generally referred to as an “agency cost” problem. Whenever one party (here, the managers) acts as an agent for another (shareholders and/or other constituencies of the firm), agency cost issues arise. For an argument that agency costs are the central issue in all of corporate law, see REINER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW (2004). For a discussion of managers’ conflict of interest when a company is financially troubled, see David A. Skeel, Jr., Corporate Anatomy Lessons, 113 YALE L.J. (forthcoming 2004) (reviewing KRAAKMAN ET AL., supra).
lenders often insist that the current managers be replaced by a new CEO or CRO, or at the least that a CRO be brought in to work with the board of directors. If so, the CEO is negotiating on behalf of a company she won’t be working for in a few weeks. If the lenders dangle the prospect of a lucrative severance package during the negotiations, the CEO may focus more on the severance package than on the best interests of the company.

The CEO’s incentives are less troubling if the terms of her exit aren’t on the table. Most CEOs are faithful to their company, and want to do what’s best for its future. But there still is reason to worry. The fact remains that a CEO who will soon be replaced isn’t likely to be the best representative of the company’s interests.

Suppose instead that the CEO is not the one who is leading the negotiations with the company’s lenders. In reality, the board of directors—or more likely, some or all of its outside directors—often asserts an increasing amount of control as a company’s fortunes decline. The outside directors’ decision-making incentives are likely to be much less skewed than that of the CEO. But their perspective is still far from ideal. Although outside directors usually have much less at stake than the CEO, they too are looking at the end of the line. Most will be long gone by the time the company’s bankruptcy case comes to an end. As a result, we can not simply assume that the financing terms that the directors negotiate will be optimal.

For both the managers and the directors, bankruptcy is a classic end-game situation. When the relevant decision makers are in an end-period, we need to take a close look at the decisions they make.

B. The Trouble with Loan-Oriented DIP Financing

I have focused thus far on the debtor’s decision making team. It takes two to tango, however; the DIP lenders obviously have a major say in the terms of the financing. If the DIP lenders have an incentive to maximize the value of the firm in bankruptcy, their incentives may counteract the distortion on the debtor’s side.

In some respects, they do. The most obvious benefit of DIP lending oversight is that DIP lenders have a strong interest in preventing the debtor’s managers from taking risks that jeopardize the value of the

53 This has long been true, and is even more true today. For evidence of the high rate of managerial turnover in bankruptcy in the late 1980s and early 1990s, see, for example, Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default, 27 J. FIN. ECON. 355 (1990); Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669 (1993).
firm. If the DIP lender is fully secured, its principal concern is that the value of its collateral could deteriorate. If the DIP-Bank makes a $100 loan, for instance, and the loan is secured by assets that are currently worth $120, the lender will veto activities that could jeopardize that $20 equity cushion. This means no sudden and risky shifts in corporate strategy. It also may mean shutting the corporation down if keeping the corporation going is a money losing proposition—if, as economists put it, the distress is economic rather than simply financial. If the business no longer makes sense, simply keeping the doors open is a value-destroying proposition.

Although DIP lenders’ efforts to clamp down on risk-taking have counteracted one of the most pressing problems in Chapter 11, the expansion of loan-oriented DIP lending has introduced two significant problems of its own. The first is the danger that the DIP lender will tighten the screws too much, that it will discourage even appropriate risk-taking. To stick with the simple example from the previous paragraph, assume that the company could invest the $120 of assets in a project that will be worth either $200, if it succeeds, or $80 if it doesn’t. If there is a fifty percent likelihood of each outcome, the project is worth $140 to the company and should be pursued. But this may not be the way DIP-Bank looks at it. What DIP-Bank sees is a fifty percent possibility that the venture will fail and the lender will get only $80, rather than the full $100 it is owed. DIP-Bank may pay less attention to the $200 upside, since its own upside is fixed at $100. As a result, DIP-Bank has an incentive to squelch the transaction, knowing that it will be paid in full if the company sticks with the assets it has.

Now, there is at least one significant countervailing factor from DIP-Bank’s perspective. DIP-Bank’s horizon may extend beyond the Chapter 11 case if it expects to continue its lending relationship with the reorganized firm. In this case, DIP-Bank’s stake is more than simply repayment of the $100. If the present value of DIP-Bank’s expected post-bankruptcy loans in the event that the debtor’s venture succeeds is greater than $20, DIP-Bank may be willing to take the risk, despite the possibility that it will not get paid in full on its current loan. The possibility of an ongoing lending relationship may give DIP-Bank an

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54 A company that is in financial distress needs to be restructured, either through a sale or through a reorganization that scales down its debt. A company that is in economic distress is not viable.

55 The project has a positive net present value, since its present value is $140, whereas the assets currently are worth only $120.

56 Alternatively, the debtor (or its unsecured creditors) could agree to pay the lender a portion of the proceeds—say, forty-one additional dollars—if the venture succeeds, in return for the lender’s agreement to let the venture go forward. But the bankruptcy framework discourages side payments of this sort.
equity-like stake in the upside potential of the company.\textsuperscript{57}

Although the existing data are quite limited, one finding can be seen as consistent with the view that DIP lenders’ stake in the future offsets their tendency toward excessive risk aversion. If DIP lenders have little taste for risk, we might expect to find them pressuring too many firms to liquidate their assets rather than reorganizing. Yet the early DIP financing studies have consistently found that debtors who obtain DIP financing are more likely to reorganize—not less—than debtors who don’t.\textsuperscript{58} Perhaps this means that DIP lenders are picking firms whose prospects are promising, and are shepherding these firms through to successful reorganizations, after which the DIP lender will continue its lending relationship with the company. But perhaps not. The significance of the finding that DIP-funded firms are more likely to reorganize isn’t entirely clear, given that so many of the cases that researchers code as “reorganizations” look an awful lot like liquidations on inspection.\textsuperscript{59}

Another important and suggestive data point is that DIP lenders often include takeout fee provisions in the DIP financing agreement. If the DIP financier participates in the debtor’s exit financing, it will waive the fee. But if the debtor’s assets are sold or the debtor obtains exit financing from another lender, the DIP is entitled to receive the takeout payment. The inclusion of takeout fees can be seen as underscoring the DIP financier’s commitment to an ongoing relationship with the debtor, but it also has the effect of simply increasing the DIP financier’s control over the debtor’s decision making.

The rather muddy conclusion we are left with is this: the prospect of post-bankruptcy business counteracts a DIP lenders’ incentive to clamp down even on beneficial risk-taking, but it is not clear how strongly this influences a DIP lender’s decision making. Despite the hedging, however there is an important takeaway point: our comfort level with DIP lender control should increase as the importance to the DIP lender of its post-petition relationship with the debtor increases; we

\textsuperscript{57} See Skeel, supra note 37, at 121. For an analogous observation about bank lending in general, see David A. Skeel, Jr., An Evolution Theory of Corporate Law and Corporate Bankruptcy, 51 VAND. L. REV. 1325, 1394 n. 282 (1998), noting that “a bank’s ongoing interest in its borrower’s success gives it an equity-like stake in the borrower’s future... since the firm’s future success means future loans for the bank.” Bob Rasmussen makes a similar point, characterizing the lender’s decision whether to force a sale or to continue lending as a real option. Robert K. Rasmussen, Secured Credit, Control Rights and Real Options, 25 CARDOZO L. REV. 1935 (2004).

\textsuperscript{58} See, e.g., Chatterjee et al., supra note 44; Daija et al., supra note 5; Maria Corapeto, Does Debtor-in-Possession Financing Add Value? (Oct. 6, 2003) (unpublished manuscript).

\textsuperscript{59} A recent article by Douglas Baird and Bob Rasmussen points out, for instance, that seven of the large, publicly held debtors that exited from bankruptcy in 2002, and were treated as “emerging” under a plan of reorganization by a leading bankruptcy database, actually involved sales of assets. Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 STAN. L. REV. 673, 676 (2003).
should be more concerned if the likelihood of an ongoing relationship is remote. I will return to this point below, after we consider the second danger with DIP financer control.

The second concerns stems from the conditions under which the DIP loan is initially authorized, rather than from the way the lender wields its influence thereafter. Nearly sixty percent of the time, the debtor’s post-petition financer is a bank (or banks) that had already lent money to the debtor prior to bankruptcy. In these cases, the new loan often subsumes an existing loan. To return to our example, if the debtor owed DIP-Bank $40 under a prior loan at the time of bankruptcy, the $100 DIP loan might consist of the existing $40 plus $60 of fresh lending under a revolving credit agreement. This is where problems can arise. If the pre-petition loan is unsecured, or undersecured, the lender may try to use the DIP financing facility to beef up its security. If the existing $40 loan is secured by collateral worth $30, and DIP-Bank negotiates for an expanded collateral pool worth $120 in connection with the DIP financing, the effect is to convert its undersecured pre-petition loan ($30 secured, $10 unsecured) into a fully secured loan. DIP lenders achieve a similar effect by structuring the DIP lending facility so that the debtor’s post-petition payments pay off the earlier loan first, which means that any amounts still outstanding at the end of the case will be due under the fully secured post-petition portion of the loan.

The debtor may sometimes seem to benefit from this kind of bootstrapping arrangement. After all, a lender that can shore up its pre-petition loan may be willing to lend to debtor on better terms than a lender who is starting from scratch. The little boost to the earlier loan may mean a better interest rate, or even the difference between obtaining a loan and not getting one. But this is exactly the problem. If the debtor’s condition is hopeless, it may be better if the company is

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60 See, e.g., Dahya et al., supra note 5, at 265 (finding that pre-petition lenders serve as DIP financer in fifty-eight percent of cases).

61 The use of the new loan’s collateral to secure a pre-petition loan, some or all of which was unsecured, is referred to as cross collateralization. Courts have generally refused to allow the cross collateralization of an obviously unsecured or undersecured pre-petition loan. See, e.g., Shapiro v. Saybrook Mfg. Co., 963 P.2d 1490, 1494-95 (11th Cir. 1992). But it is not always entirely clear whether the old loan is fully secured. In these cases, the bank may be able to claim that the old loan was secured, and then subsume the old loan into the DIP financing, thus achieving a more subtle form of cross collateralization. For discussion of courts’ treatment of cross collateralization, see, for example, Scott D. Cousins, Post-Petition Financing of Dot-Coms, 27 DEL. J. CORP. L. 759, 798-800 (2002).

62 Bruce Markell notes that “many of the [DIP lending] facilities I’ve seen ‘roll up’ the pre-petition debt into the first DIP draw,” thus assuring that the pre-petition loan will be fully paid. E-mail from Bruce A. Markell to David Skeel (Feb. 10, 2003) (on file with author); see also Cousins, supra note 61, at 800-01 (discussing roll-up financing). The priority of the new loan assures that it must be paid in full to confirm a reorganization plan. 11 U.S.C. § 1129(a)(9) (2000).
shut down now rather than later. Using the special priority of § 364 to make a new loan possible can destroy value by postponing the shutdown date.63

Enhanced security and early payoff aren’t the only strategies that DIP lenders use to buttress their pre-petition status. Pre-petition lenders have also insisted that the debtor waive its right to challenge any pre-petition payments as preferential transfers.

How should courts respond to these dangers? The most obvious point—but one worth underscoring—is that courts should refuse to approve DIP financing agreements that enhance the security of a pre-petition loan, and they should prohibit provisions that purport to protect the lender from preference attacks and other avoidance actions. Consistent with this, both Delaware and New York, the leading bankruptcy venues, have issued guidelines indicating that they will not permit preference waivers.64

Should courts adopt a more sweeping solution to DIP lender bootstrapping? One obvious possibility would be for courts to simply prohibit pre-petition lenders from participating in a post-petition financing facility. Recall that this is essentially the same strategy the New Deal reformers used to loosen the Wall Street banks’ grip on large scale reorganization in the 1930s.65 Would an analogous proposal improve DIP financing today?

It might, but the prospect of a blanket prohibition raises several significant concerns. First, existing lenders have better information about the debtor than anyone else, and excluding them from the DIP financing sweepstakes would squander the benefits of this information. The informational advantages of existing lenders cut both ways, however. Although existing lenders are particularly well-positioned to decide whether to finance the debtor’s bankruptcy, their informational advantage may also have a chilling effect on other lenders’ willingness to provide a loan.66

Two other objections seem more telling. The first is that prohibiting existing lenders from participating in a DIP loan could promote wasteful strategic behavior on the eve of bankruptcy. Debtors

65 See supra note 27 and accompanying text.
66 For a discussion of the informational advantage that a debtor’s lender has in an ongoing banking relationship, see, for example, Robert E. Scott, A Relational Theory of Secured Financing, 86 COLUM. L. REV. 901 (1989).
would be forced to tiptoe around their existing lender as they made preparations for bankruptcy, since negotiations with potential DIP lenders would signal to the existing lender that bankruptcy is eminent. The prohibition also would discourage the loan facilities companies currently set up on the eve of bankruptcy, but prior to actually making a bankruptcy filing.\footnote{See supra notes 40-41 and accompanying text.}

The second objection returns us to our earlier discussion. If we had to predict which lenders are most likely to be influenced by the prospect of continuing their lending relationship with the debtor after bankruptcy, DIP financers who also lent to the debtor before bankruptcy are a likely choice. A court that excluded pre-petition lenders from consideration would therefore be cutting off the lenders who are most likely to be influenced by the possibility of a post-petition relationship with the debtor.

These concerns suggest that prohibiting pre-petition lenders from funding the debtor post-petition would be throwing the baby out with the bathwater. Although the prohibition would solve the bootstrapping problem, it would do so at a significant cost. But what about an intermediate solution that targeted the same concern about pre-petition lenders? What if courts continued to let pre-petition lenders provide post-petition financing, but separated the old loan from the new one? If this could be done, it would address the bootstrapping problem without excluding the debtor’s pre-petition lender from the financing picture. We could keep the baby and throw out at least some of the bathwater.

The ideal way to separate old and new would be to treat them as entirely separate loans, each with its own collateral and bankruptcy treatment. Payments on the new loan would be treated as an administrative expense, and the loan would be secured by whatever lien the court approved. The old loan, by contrast, would be entitled to priority to the extent of any collateral, while the remainder would be treated as an unsecured claim.\footnote{One could imagine lenders proposing an alternative strategy under which the lender agreed to relinquish its pre-petition lien and to “reloan” the amount still owing in return for administrative priority treatment. Although administrative priority treatment is technically a lower priority than the financier’s pre-petition lien, it would enable the lender to insist on payment in cash in full at confirmation. Bankruptcy Code § 1129(a)(9)(A) (2000). If anything, this would increase the financier’s leverage. The strategy should therefore not be permitted.} The principal complication is that there often would not be enough unencumbered assets to support the new DIP loan.\footnote{The revolving credit facilities that lenders currently set up are usually secured by the company’s key assets, including its inventory and accounts receivable. See, e.g., Rasmussen, supra note 57, at 4 (noting that the loans are secured by inventory and accounts and that “the debtor is kept on a tight leash”).} Most or all will already be committed to the earlier loan. In some cases, it may be possible to allocate some of the collateral to the existing loan, and the rest to the new loan. If it isn’t, and the same
collateral secured both loans, the court could distinguish them by adopting a “last in, first out” strategy that gave precedence to the new loan both in priority and repayment. In effect, the earlier loan would be carved out and treated separately.

C. The Anti-Takeover Risk of DIP Lending: Loan-and-Control Transactions

Outside of bankruptcy, if the managers of a company walked into court with an agreement that transferred control over its board of directors and promised thirty-six percent of the company’s stock to a Bidder, without any input from the company’s shareholders, the court’s most likely response would be, “nice try.” In the corporate law context, courts are skeptical of stock lock-ups that commit a significant portion of a company’s stock to a favored bidder, since the lock-up may exclude other bidders from making a higher bid for the company. DIP financing agreement had essentially the same effect—effectively transferring control to the DIP lender without any vote by U.S. Air’s shareholders or creditors. The similarities counsel in favor of similar skepticism when DIP financing agreements dictate the terms of post-bankruptcy control.

I should start by acknowledging that the U.S. Air agreement that I have used as my principal example wasn’t quite so egregious as I have suggested thus far. The managers of U.S. Air didn’t simply tap David Bonner of Alabama Retirement on the shoulder, and offer to hand the company over to him in return for a $740 million loan. The Alabama pension emerged as the lender of choice only after a spirited competition with the Texas Pacific Group. Moreover, with this and other DIP loan agreements, shareholders and creditors aren’t shut out of the decision making process altogether. They are entitled to weigh in at both the initial hearing to preliminarily approve the DIP financing, and at the formal hearing that follows.

That’s the good news. The bad news is that the opportunity to object to a proposed DIP financing arrangement is hardly a substitute for the right to actually make the decision, which investors have with change-of-control transactions outside of bankruptcy. We also can’t

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70 For a detailed discussion of the treatment of lock-ups (including asset lock-ups and breakup fees, as well as stock options) in corporate law and bankruptcy, see David A. Skeel, Jr., Lockups and Delaware Venue in Corporate Law and Bankruptcy, 68 U. Cin. L. Rev. 1243 (2000).

71 See supra note 49 and accompanying text (describing DIP financing facility in U.S. Air case).


73 If the change in control is structured as a merger, for instance, it generally must be
take too much comfort from the fact that the Alabama pension and Texas Pacific competed for the right to finance and acquire U.S. Air. There's nothing that explicitly requires the debtor to entertain multiple offers. We don't have to look far, in fact, to find cases where the debtor's managers struck a deal with a single bidder, without getting competing bids.74

At first glance, it may seem that the Chapter 11 voting rules will take care of any problems.75 Every class of creditors and shareholders is entitled to vote on the reorganization plan that is eventually proposed.76 If it transfers control to the DIP financer too cheaply, they can simply vote no. But the DIP lender's control over the debtor's access to cash, together with the priority treatment of DIP loans, takes much of the bite out of the Chapter 11 vote. If the covenants of the DIP loan are restrictive enough—and they invariably are—the DIP financer can threaten to cut off the debtor's cash and force a liquidation unless the parties agree to the terms of the proposed plan. Since the DIP lender's loan is secured, it can make this threat without putting its own money at risk. In effect, the DIP lender has an option to take control of the company at the end of the case, and the debtor and its creditors are the ones who are paying for the option.

I do not mean to suggest that a DIP lender's use of this threat will never be in the company's best interests. In both U.S. Air and United, the DIP lender threatened to force a liquidation unless employees made significant wage and benefit concessions.77 These concessions may well have been necessary for the viability of both companies. But there's no guarantee of this, given the "head's I win" (and take control of the company), "tails you lose" (the DIP lender takes its money and goes home, and the company's assets are liquidated piecemeal) quality of DIP loans that transfer control to the DIP lenders. A DIP lender may use its control to achieve an efficient resolution of the debtor's financial

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74 American's acquisition of TWA is an illustration of a loan-and-control transaction arranged after negotiations with a single lender prior to bankruptcy. See, e.g., Carey, supra note 50, at A3 (noting that approval of "American Airlines"'s financing plan for beleaguered Trans World Airlines [was] a move rival carriers [criticized as giving] American an unfair advantage in bidding for TWA assets"). Although there was an auction of sorts for TWA's assets, American's DIP financer status gave it a tremendous informational advantage over other potential bidders.

75 This seems to be true, at least in cases that do not involve a § 363 sale of most or all of the company's assets. In these cases, approval of the § 363 sale by the court essentially ends the case, since it reduces the debtor's assets to cash and thus ends much of the uncertainty as to who is entitled to what.

76 See, e.g., 11 U.S.C. § 1129(a)(8) (requiring approval by each class of claims and interests).

77 See, e.g., Maynard, supra note 45, at C1 (discussing the threat to force liquidation in U.S. Air); Carey, supra note 43, at A3 ("UAL Corp. said it intends to shed 14% of its management and salaried employees . . . to lower expenses to meet the strict terms of its debtor-in-possession financing package.").
distress, whether through a reorganization, a sale or a piecemeal liquidation. But it may also use its control to divert value from other creditors.78

Before DIP loans became a popular mechanism for taking control in a bankruptcy case, claims trading was the takeover device of choice.79 The principal strategy for an acquisition-minded bidder was to buy control of a key class of claims—usually a class of unsecured claims. Since the unsecured claims ordinarily receive most or all of the stock of the reorganized company, a bidder who bought these claims could position itself to take control after bankruptcy, and then use the bankruptcy process to further this objective.80 In recent years, claims trading has been hamstrung by a variety of impediments, the most important of which is the risk that extensive claims trading will destroy the debtor’s ability to use any net operating losses (“NOL”) that it accumulated prior to bankruptcy.81 If we put these problems to the side for the moment, and simply compare claims trading and DIP loans as mechanisms for transferring control, the differences are striking. Unlike the DIP lender, a bidder who has traded claims has a direct stake in the treatment of the debtor’s pre-bankruptcy claims. If the claims trader diverts value from the debtor’s pre-petition creditors, it also is diverting value from itself. To be sure, this doesn’t guarantee that the claims trader’s incentives are always above reproach. It is possible, for instance, that a claims trader would be willing to jeopardize the payout to itself and other creditors if this increased the likelihood that the trader would wind up in control when the dust settled.82 But claims traders are much more likely than DIP financiers to have both real money at risk, and a financial stake in the treatment of the debtor’s pre-petition creditors.

It is no doubt apparent where this is going. The basic implication is that we should focus on facilitating claims trading, on the one hand,

78 The concern that senior creditors might divert value from general creditors to themselves or other parties is a longstanding worry that gave rise to an important early Supreme Court decision. See Northern Pacific v. Boyd, 228 U.S. 482 (1913). There are important similarities between the dangers addressed in Boyd, which dates back to the equity receivership era, and the possibility of abuses in loan-and-control DIP financing arrangements.

79 The contrast between debtor-in-possession financing and claims trading was suggested to me by Aviram Hazak, and is a topic he is exploring at length in a work-in-progress.

80 This was the strategy used by Japonica Partners in the bankruptcy of Allegheny International, one of the most prominent cases in which claims trading played a central role. Japonica's votes were disqualified by the bankruptcy court, but it nevertheless succeeded in obtaining control in connection with Allegheny's reorganization. See e.g., In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990) (confirmation decision by the bankruptcy court).

81 For a recent overview, see, for example, John J. Rapisardi, Thou Shalt Not Trade: Restrictions on Trading in Bankruptcy, N.Y. L.J., Mar. 14, 2003, at 3.

82 Japonica's actions in Allegheny, where it threatened to veto any proposed reorganization plan other than its own, can be seen as an illustration.
and on reining in loan-and-control transactions, on the other. Start with claims trading. As noted above, the treatment of NOLs is the most important impediment to active claims trading. Under current tax law, a reorganized company that wishes to use all of its pre-bankruptcy NOLs must show that at least fifty percent of its stock is held by existing shareholders and creditors. Here's the catch: a creditor only counts toward the fifty percent if it has held the debt for at least eighteen months before the bankruptcy filing. Because significant claims trading can jeopardize a company's NOLs, courts have agreed to limit claims trading in a number of recent cases. One obvious way to reverse the chilling effect this has on claims trading would be to relax the creditor ownership restrictions for preserving NOLs.

The underlying intuition is that the market for corporate control shouldn't disappear when a company files for bankruptcy. In at least one respect, the analogy to corporate law suggests the need for additional regulation in connection with more vigorous claims trading. Under the securities laws, an investor who acquires more than five percent of a company's stock is required to disclose that interest. In bankruptcy, by contrast, the securities laws are called off, and there are no formal disclosure requirements for claims trading activity. If the opportunities for claims trading were enhanced, it would also make sense to implement comparable disclosure requirements. An investor who acquired twenty percent of any given class of claims, for instance, should be required to disclose this fact.

Turn now to debtor-in-possession financing. Given the distorting effect that DIP lender status has in the loan-and-control context, there is a strong argument for prohibiting sales directly to the DIP lender. As a practical matter, the DIP lender may end up with a significant block of shares, through the reorganization process in some cases, but any DIP financing provisions that explicitly provide for a post-bankruptcy stake should be prohibited. The goal is not to discourage sales of assets, of course—just sales to the DIP financier.

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83 I should note that not everyone believes that claims trading is beneficial. For criticism of its effect on Chapter 11 negotiations, see, for example, Miller & Waisman, supra note 46, at 20-21; Frederick Tung, Confirmation and Claims Trading, 90 NW. U. L. REV. 1684 (1996). In my view, the criticisms underestimate the value of having an active market for corporate control in bankruptcy.

84 See, e.g., Rapisardi, supra note 81, at 3 (describing the rules for retaining NOL's after a reorganization).


86 See 11 U.S.C. § 1145 (2000). In the early 1990s, bankruptcy courts began scrutinizing the purchase and sale of claims, but Rule 3001(e) was amended in response to this trend. Current Rule 3001(e) requires only that the court and the transferee be notified of the transfer of a claim.
CONCLUSION: LESSONS FOR OTHER JURISDICTIONS

The previous three parts of this article have traced the evolution of debtor-in-possession financing from its humble origins in the receiver’s certificates of the equity receivership era to the dominant role DIP financiers play in many current bankruptcy cases. In the old days, receiver’s certificates were used exclusively for financing the reorganization process; currently, the DIP financing agreement is often the single most important governance lever in bankruptcy.

The expanded role of DIP financing is, in many respects, a good thing. DIP financiers have filled the governance vacuum left by the ouster of J.P. Morgan and the other Wall Street banks from corporate reorganization in the 1930s, and by the subsequent removal of the bankruptcy trustee and the SEC with the enactment of the 1978 Code. But there are dark sides to the expanded use of DIP financing as well. I have argued for restrictions both on loan-oriented DIP financing transactions—particularly those that involve a pre-petition lender—and on the use of DIP loan agreements to effect takeovers.

In recent years, as lawmakers and commentators have compared the bankruptcy regimes of different jurisdictions, they have increasingly pointed to DIP financing as one of the most important attributes of Chapter 11 in the U.S. The significance of DIP financing in the U.S. raises the question of what lessons its history and current use may hold for other countries. Let me suggest two. First, the expansion of DIP financing has been tied to the distinctive interest group dynamic and political shocks of the U.S. context. In effect, the new DIP financiers have emerged as a substitute for the investment banks that dominated large scale reorganization until the New Deal. In other interest group environments, one might expect to find a different governance profile, even if a DIP financing provision were incorporated into the bankruptcy framework. In many countries, for instance, a court-appointed administrator is appointed in bankruptcy. This administrator is likely to dominate governance in bankruptcy, even if the bankruptcy framework formally provides for DIP financing.

Second, the DIP financing provision will only provide access to cash if DIP financiers are assured priority for their loans, and if many firms that default do so while they are still viable. Hungary, for instance, adopted a provision based on § 364 for its bankruptcy laws, but didn’t provide special priority for the DIP lender. As a result, it

87 See, e.g., WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY & CREDITOR RIGHTS SYS. 48 (Apr. 2001) (recommending priority funding in principle 18).

has seen less business than the proverbial Maytag repairman from the old television ad. Similarly, in jurisdictions where companies that fail are very unlikely to still be viable, a DIP loan provision will not get a great deal of use even if it promises special priority.

The moral, here as in other contexts, is that provisions that are transplanted from one nation's laws into another often have unintended consequences. Even in the U.S., which pioneered DIP financing, the effect of the DIP financing provision has been far different than anyone would have expected. Sometimes, as a lawyer once said in a very different context, "what looks small may not be as small as you think," and "what looks large may, in fact, be larger than you think. What looks large may actually be larger than you think!" \(^9\)

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