By Scott A. Wolfson and Anthony J. Kochis

Unflopping the Debtor: Finding Fairness in Financing

Scott A. Wolfson
Wolfson Bolton PLLC
Troy, Mich.

Anthony J. Kochis
Wolfson Bolton PLLC
Troy, Mich.

Scott Wolfson and Anthony Kochis are attorneys with Wolfson Bolton PLLC in metropolitan Detroit.

Unsecured creditors often do not have a sufficient financial incentive to justify retaining their own counsel to read, much less challenge, overreaching financing orders, which means that the job falls exclusively on committee counsel. This is an important task, because the era of reasonableness in financing orders, if it ever existed, appears to have ended.

Left unchallenged, interim financing orders may all but ensure that unsecured creditors will recover nothing of significance. The debtor will invariably have "flopped" on lender requests detrimental to the estate to enable the debtor to obtain much-needed post-petition cash. Even chapter 5 recoveries are often pledged for the lender's exclusive benefit. Case law offers some hope for unsecured creditors, which must be exploited to level, or at least lower the tilt of, the chapter 11 playing field.

Background

The Bankruptcy Code requires the formation of an unsecured creditor's committee in a chapter 11 case "as soon as practicable after the order for relief" has been entered.[1] While the language of the Code suggests a sense of urgency in forming a committee, practical problems often prevent immediate formation. This is especially true in smaller chapter 11 cases, in which the U.S. Trustee may have difficulty locating creditors willing to serve. A non-mega debtor may also have difficulty finding debtor-in-possession (DIP) financing from sources other than its pre-petition lender, resulting in a tumultuous beginning to the bankruptcy case unless and until the pre-petition lender decides to serve as the DIP lender. Regardless of the source of financing, the DIP financing order will likely have been approved on an interim basis before the committee is formed, creating a showdown between the newly appointed committee counsel and the DIP lender over the order's terms.

Having arrived late to the party, committee counsel may find itself scrambling to understand a large amount of information in a compressed timeframe to prepare to challenge the financing order. The lending relationship may cover years of loan documents and amendments.

Take the following example: Before the committee is formed and committee counsel retained, the court grants approval of an interim financing order. A review of the interim financing order reveals that the following provisions have been approved on an interim basis: cross-collateralization in favor of the DIP lender of debtor's pre- and post-petition collateral, liens on chapter 5 avoidance actions in favor of the DIP lender, debtor's waiver of its ability to surcharge the DIP lender's collateral that purports to bind any successor chapter 7 trustee, allocation of 1 percent of the professional fee budget to the committee, and admissions by the debtor of the purported validity and extent of the DIP lender's liens. What is committee counsel to do?

For starters, committee counsel should conduct a thorough review of the collateral position of the DIP lender, with an eye toward revealing any unperfected liens. Regardless of the size of the debtor or its law firm, failures to perfect happen. Next, regardless of whether committee counsel uncovers unperfected liens, committee counsel should attempt to negotiate revisions to the financing order with the DIP lender. Is the DIP lender willing to concede some or any of the provisions that it insisted on inserting in the interim financing order? Were the most outrageous provisions the secured lender included in the interim order in fact baked-in "gives" in order to provide the committee with a moral negotiating victory, or does the secured lender intend to take "draconian" to a new level? Absent significant concessions, committee counsel must prepare to object to entry of the final financing order. The following are some of the most common arguments against the order provisions in the above hypothetical.

Cross-Collateralization in Favor of the DIP Lender

While controversial, cross-collateralization is often used, even among courts that discourage its use.[2] Cross-collateralization involves securing pre-petition debt with liens on post-petition assets. The reason why cross-collateralization is controversial is because in the case of an undersecured creditor, it could allow the creditor to become fully secured, thus bypassing the priority scheme of the Bankruptcy Code.[3] In order to allow cross-collat-

1 11 U.S.C. § 1102(a)(1).

2 *In re Ellingsen MacLean Oil Co.*, 834 F.2d 599, 602 (6th Cir. 1987) ("Cross-collateralization, however, although controversial, is often used, and even the courts that discourage it have approved its use. Because cross-collateralization seems to be used and approved, and appears to be a valuable financing tool in arranging post-petition credit to keep debtors in reorganization going, Congress would not have intended to exclude all cross-collateralization orders categorically from section 364(e)'s protection.") (internal citations omitted).

3 *See In re Willingham Investments Inc.*, 203 B.R. 75, 79 (Bankr. M.D. Tenn. 1996); *see also Shapiro v. Saybrook Mfg. Co. (In re Saybrook Mfg. Co.)*, 963 F.2d 1490, 1496 (11th Cir. 1992) (holding that cross-collateralization is not permissible under 11 U.S.C. §§ 364 or 105).

eralization, some courts have required a secured creditor to meet a four-element test: (1) absent the proposed financing, the debtor's business operations would not survive; (2) the debtor is unable to obtain alternative financing on acceptable terms; (3) the proposed lender will not accede to less-preferential terms; and (4) the proposed financing is in the best interests of the credit body.[4] Committee counsel should examine whether alternative financing sources are available to the debtor and the extent to which the debtor shopped the loan pre-petition. If none are available, committee counsel should ensure that a sound business justification exists to support this disfavored form of financing.

Similar to cross-collateralization is a "roll-up," which involves payment of pre-petition debt through the application of the DIP financing proceeds. While technically distinct from cross-collateralization, courts that have rejected roll-ups typically rely on the same reasoning used to reject cross-collateralization.[5]

Liens on Chapter 5 Avoidance Actions

Many DIP lenders insist on a lien on chapter 5 avoidance actions, at least in the first draft of their orders. No longer an automatic give by lenders, DIP lenders may insist upon a lien on chapter 5 recoveries to provide additional security for their post-petition loan. There are two primary arguments in opposition to DIP lender liens on chapter 5 recoveries.

The first argument is that an all-asset pre-petition lien does not attach to avoidance-action recoveries. While DIP lenders with pre-petition liens in the proceeds of a debtor's collateral may argue that their pre-petition lien attaches to chapter 5 recoveries post-petition under 11 U.S.C. § 552(b)(1), courts evaluating this argument have rejected it.[6]

The second argument against granting liens on chapter 5 recoveries in favor of DIP lenders is that only the trustee, acting on behalf of all creditors, has the right to recover chapter 5 avoidance actions, and permitting a DIP lender to have a lien on these recoveries would "frustrate the policy of equal treatment of creditors" under the Code.[7] Committee counsel should be prepared to push back on this issue because chapter 5 recoveries are often the most important, if not the only, potential source of recovery for unsecured creditors.

Waiver of Ability to Surcharge

DIP lenders may also insist on a debtor's waiver of its ability to surcharge the DIP lender's collateral under 11 U.S.C. § 506(c),[8] which DIP lenders often argue is binding on a successor chapter 7 trustee under the principles of *res judicata*.[9] In fact, the interim order may expressly provide that it is binding on a subsequently appointed chapter 7 trustee. Some courts have rejected a debtor's surcharge waivers, holding them *per se* unenforceable because they attempt to override the express language of the Bankruptcy Code.[10]

Committee Budget

An interim financing order typically contains a budget under which the DIP lender is willing to fund the debtor's operations and within which the debtor must operate during the chapter 11. Committee counsel may be surprised, or at least discouraged, when reviewing the interim financing order to learn that the budget for the committee is minuscule. Adding insult to injury, interim payment of committee professional fees may be subject to disgorgement absent a carve-out[11] of the DIP lender's collateral.

Many courts, however, have recognized the importance of adequate committee funding to enable it to fulfill its statutory duties under 11 U.S.C. § 1103.[12] The lack of protection for professionals' fees and costs has been found to "sorely prejudice" the collective rights and expectations of all parties-in-interest.[13] The statutory rights of a committee under 11 U.S.C. § 1103 are hollow unless adequate funding is available to permit the committee to retain competent counsel.

Concessions Regarding DIP Lender's Liens on Collateral

The DIP lender often receives the debtor's concession of the validity, perfection and enforceability of the DIP lender's pre-petition liens in the debtor's collateral. While is it common for courts to allow these provisions, many courts will condition the concession on the committee's right to challenge the DIP lender's liens.[14] Committee counsel should pay careful attention to the breadth of the debtor's waivers in the interim financing order and ensure that the committee has the ability to challenge the validity and perfection of the DIP lender's pre-petition liens after a sufficient review period.

4 *In re Roblin Industries Inc.*, 52 B.R. 241, 244 (Bankr. W.D.N.Y. 1985); *see also In re Ames Dept. Stores*, 115 B.R. 34, 39 (Bankr. S.D.N.Y. 1990) ("Because cross-collateralization of a pre-petition loan with post-petition assets may elevate an unsecured or undersecured loan to fully secured status ahead of other similar claims, creditors are entitled to be heard on whether the potential benefits of the arrangement in preserving a business outweigh the prejudice to them.").

5 *See In re Equalnet Communs. Corp.*, 258 B.R. 368, 369 (Bankr. S.D. Tex. 2001) ("[B]ased on the Eleventh Circuit's ruling in ... *Saybrook Mfg. Co. Inc.*, 963 F.2d 1490 (11th Cir. 1992), a secured creditor's pre-petition loan balance [cannot] be paid off and/or 'rolled into' a post-petition line of [DIP] financing, with resultant enhancement of collateral position and administrative priority.").

6 *Frank v. Michigan*, 263 B.R. 538, 542 (E.D. Mich. 2000) ("The majority of courts considering [this] question have found that preference actions are unique bankruptcy devices designed specially to increase the dividend for unsecured creditors and that therefore secured creditors, even those with rights in the proceeds, can have no interest in a trustee's preference recovery.") (internal citations omitted).

7 *Official Comm. of Unsecured Creditors v. Gould Elecs. Corp.*, 1993 U.S. Dist. LEXIS 14318 (N.D. Ill. Sept. 20, 1993).

8 "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all *ad valorem* property taxes with respect to the property." 11 U.S.C. § 506(c).

9 *See InteliQuest Media Corp. v. Miller (In re InteliQuest Media Corp.)*, 326 B.R. 825 (B.A.P. 10th Cir. 2005).

10 *In re Brown Bros. Inc.*, 136 B.R. 470, 474 (W.D. Mich. 1991) (holding that waiver of § 506(c) "not enforceable in light of the congressional mandate that a trustee have the authority to use a portion of secured collateral for its preservation or proper disposal"); *In re Colad Group Inc.*, 324 B.R. 208, 224 (Bankr. W.D.N.Y. 2005) (refusing to enforce § 506(c) waiver, noting that "debtor and its secured creditor do not constitute a legislature. Thus, they have no right to implement a private agreement that effectively changes the bankruptcy law with regard to the statutory rights of third parties").

11 *In re Hotel Syracuse Inc.*, 275 B.R. 679, 683, n.4 (Bankr. N.D.N.Y. 2002) (defining "carve out" as "an agreement by a party secured by all or some of the assets of the estate to allow some portion of its lien proceeds to be paid out to others, *i.e.*, to carve out of its lien position.... Carve outs are ... common in Chapter 11 cases in favor of debtor's attorneys as part of cash collateral agreements").

12 *See In re Ames Dept. Stores*, 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990) ("Indeed, it has been the uniform practice in this Court ... to insist on a carve out from a super-priority status and post-petition lien in a reasonable amount designed to provide for payment of the fees of debtor's and the committees' counsel and possible trustee's counsel in order to preserve the adversary system. Absent such protection, the collective rights and expectations of all parties-in-interest are sorely prejudiced."); *In re Barbara K Enters.*, 2008 Bankr. LEXIS 1917, 23-24 (Bankr. S.D.N.Y. June 16, 2008) ("[T]he court then must consider whether the terms of the proposed financing 'would tilt the conduct of the bankruptcy case; prejudice, at an early stage, the powers and rights that the Bankruptcy Code confers for the benefit of all creditors; or leverage the Chapter 11 process by preventing motions by parties-in-interest from being decided on their merits.'" (citing *In re Ames Dept. Stores*)); *In re Evanston Beauty Supply Inc.*, 136 B.R. 171, 177 (Bankr. N.D. Ill. 1992) ("Negotiated 'carveouts' have been the subject of various decisions and are viewed as being necessary in order to preserve the balance of the adversary system in reorganization.").

13 *In re Ames Dept. Stores*, 115 B.R. at 38.

14 For example, in the Eastern District of Michigan, the Local Rules require that a debtor give an official committee 14 days to object to a financing order after it is served with the financing order. *See* E.D. Mich. LBR 4001-2(c)(5). In Delaware, a motion to approve a financing order must specifically highlight provisions related to the validity and perfection of a secured creditor's liens and whether there is a waiver by the debtor absent a 60-day window of investigation for any creditor's committee. *See* Del. Bankr. L.R. 4001-2(a)(1)(B).

Conclusion

The financing order often shapes the entire chapter 11 case for unsecured creditors. Committee counsel must be ready to move swiftly and push back against overreaching provisions in the financing order. Unsecured creditor participation in the chapter 11 case will typically be rendered perfunctory if the financing order approved in the committee's absence is not modified. abi