DIP FINANCING: WHAT'S NEW; WHAT'S NOT; AND WHAT'S COMING

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DIP FINANCING: WHAT'S NEW; WHAT'S NOT; AND WHAT'S COMING

I. The Enforceability of Make-Whole Provisions and No-Call Provisions in Bankruptcy

No-call provisions prevent a borrower from prepaying a loan during a specified time period. By limiting the ability of borrowers to prepay, lenders protect their expected yield by ensuring that the loans will be outstanding (and earning interest) for a minimum period of time.

Make-whole provisions (whether labeled as “make-whole”, “yield maintenance”, early termination premiums” or “prepayment premiums”) in credit documents provide for a premium or fee when a creditor does not recognize the economic benefits expected for the duration of the original loan. Often, these premiums are stated as a percentage of the original commitments, but more sophisticated provisions attempt to set forth a formula to calculate the lost profits over the lifetime of the original loan.

In bankruptcy, no-call provisions are rarely, if ever, enforced via specific performance. *See In re Calpine Corp*., 365 B.R. 392 (Bankr. S.D.N.Y. 2007) *affd as modified by HSBC Bank USA, Nat'l. Ass'n. v. Calpine Corp.*, No. 07 CV 3088, 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010) (with the Bankruptcy Court decision referred to as “*Calpine I*” and the District Court decision “*Calpine II*”). However, some courts allow creditors to file claims for damages relating to the breach of the no-call provisions, allowing the no-call provisions to provide the same type of protection as a make-whole provision.

Although courts regularly enforce these clauses outside of bankruptcy, more frequently they are challenged as part of a bankruptcy proceeding by creditors whose recoveries are substantially diluted by the make-whole premiums. In that context, bankruptcy courts typically ask three questions to determine whether to enforce make-whole provisions:

1. Is the payment required under the parties' contract? *See In re Energy Futures Holdings Corp*., 540 B.R. 96, 104 (Bankr. D. Del. 2015) (Sontchi, J.) (“[R]egarding make-whole or prepayment premiums, 'a lender is not entitled to prepayment consideration after a default unless the parties' agreement expressly requires it.”). *See also US Bank Trust Nat'l Ass'n. v. AMR Corp. (In re AMR Corp*.), 730 F.3d 88 (2d Cir. 2013); *In re MP Silicones, LLC*, No 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

Many courts cite *In re Solutia Inc*. for this proposition, where Judge Beatty held that the “plain vanilla language” of the notes in question, when evaluated under state contract law, did not provide the creditors any right to prevent prepayment after the notes automatically accelerated upon the filing of the bankruptcy petition. 379 B.R. 473, 484 n.7, 489 (Bankr. S.D.N.Y. 2007) (“Perhaps the parties negotiated on the subject but were unable to reach an agreement. It may simply, although less probably, be that this subject was overlooked. In either case, the court cannot supply what is absent.”).

The Second Circuit endorsed this approach when it focused exclusively on the contract language of certain Indentures to find that the make-whole premiums were not due after the debt was accelerated due to an event of default. *In re AMR Corp.,* 730 F.3d at 100-01 (2d. Cir. 2013) (citing In re *Solutia*).

In order to avoid this issue, lenders are well-advised to revise their forms to make clear that a prepayment premium or make-whole premium is triggered by reason of acceleration, whether as a result of the commencement of the case or otherwise. For example, in *In re CP Holdings, Inc.*, 332 B.R. 380, 382 (W.D. Mo. 2005), the provisions stated that "if the holder of this Note accelerates the whole or any part of the principal sum. . . the undersigned waives any right to prepay. . . and agrees to pay a prepayment premium." More particularly, a well-drafted premium provision will provide that the premium is payable upon acceleration by the lender or upon the automatic acceleration typically trigger by commencement of a bankruptcy case. *See In re School Specialty, Inc.*, No. 13-10125, 2013 WL 1838513 at *1 ("Upon either prepayment or acceleration of the Term Loan, the Debtors were required to pay an 'Early Payment Fee.")

How Courts Treat Ambiguous Make-Whole Clauses

What happens when a make-whole provision does not unambiguously state the type of prepayments that trigger the fee? Courts have provided a variety of answers to what is considered a "voluntary prepayment".

Several courts have addressed whether, if a loan is accelerated, it can still be prepaid. Most courts say no, since the acceleration itself changes the maturity date, preventing any kind of prepayment. For example, in *Delaware Trust Co. v. Energy Future Inter. Holding Co., LLC (In re Energy Holdings Corps*., 527 B.R. 178, 195 (Bankr. D. Del. 2015), Judge Sontchi explained "[o]nce the maturity date is accelerated to the present, it is no longer possible to prepay the debt before maturity. Acceleration therefore does not trigger the Trustee's right to prepayment consideration under the Optional Redemption provision."

Likewise, even if there is acceleration, the creditor still must show prepayment. The Fifth Circuit denied a prepayment premium where the contract lacked a provision requiring the premium upon acceleration due to a bankruptcy filing and where no actual prepayment had been made. *Bank of NY Mellon v. GC Merchandise Mart, LLC (In re Denver Merchandise Mart, Inc.)*, 740 F.3d 1052 (5th Cir. 2014). The contract provided for a prepayment premium only when there was an actual prepayment; although the loan had been accelerated, acceleration alone was not enough to trigger the prepayment penalty. 740 F.3d at 1058-59 ("[T]here is no language in the Note which would *deem* the prepayment to have been made in the event of acceleration for any reason."). If a bankruptcy debtor is able to avoid making prepayments until the make-whole provisions have been satisfied, it can likely avoid the fees altogether.

However, depending on the terms, acceleration may not necessarily prevent enforcement of a generic make-whole provision. In *In re Chemtura*, the contract provided that the make-whole fees were due if there was a prepayment before the "Maturity Date" 439 B.R. 561, 601 (Bankr. S.D.N.Y. 2010). The contract defined that term as a date: June 1, 2016. *Id*. So, even when the Maturity—a separately defined term—was accelerated, the make-whole provision was capable of being triggered if prepayments were made before June 1, 2016. *Id. See also In re Imperial Coronado Partners, Ltd*., 96 B.R. 997 (B.A.P. 9th Cir. 1989) (because the debtor could have reinstated the loan under 11 U.S.C. § 1124(2), the decision to pay the secured creditor after a § 363 sale of the property was a voluntary prepayment).

Can a Creditor Decelerate a Loan in Order to Collect the Make-Whole Provision?

If acceleration often prevents collecting make-whole fees, can a lender waive or decelerate the loan, thus restoring the original maturity date? Courts addressing this issue have held that the automatic stay would prevent deceleration once a bankruptcy petition is filed. *In re Solutia*, 379 B.R. at 484-85; *In re AMR*, 730 F.3d at 102.

Can a No-Call Provision Provide Any Coverage?

If the make-whole provision is not enforceable, could an applicable no-call provision help a creditor who wants to protect their expected return? As noted above, no-call provisions are rarely enforced in bankruptcy via specific performance. However, courts sometimes allow creditors to seek damages for the breach of those provisions.

In *Calpine I*, the bankruptcy court focused on the lenders' "expectation of an uninterrupted payment stream" when awarding damages related to payments made in breach of the no-call provision. *Calpine I*, 365 B.R. at 399. On appeal, the District Court reversed, noting that 1) the acceleration made the debt "due and payable", negating any no-call provision and 2) even without the contractual acceleration, the Bankruptcy Code would accelerate the debt in such a way as to make the no-call provision unenforceable. *Calpine II*, 2010 WL 3835200 at *3. Since the no-call provision was unenforceable, there was no breach to justify awarding damages.

Around the same time, the Bankruptcy Court for the Southern District of Mississippi decided *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi LLC*), which did allow damages for breach of a no-call provision. 445 B.R. 582 (Bankr. S.D. Miss. 2010). Noting that the debtor was solvent, which militated towards enforcing the debtor's contractual obligations, the court found that damages for breaching the no-call provision were appropriate because it reflected the prepetition bargain the parties had made regarding the risk of fluctuating interest rates. *Id*. at 639. The creditors were granted unsecured claims for damages.

Most recently, in *Chemtura*, Judge Gerber confirmed a Chapter 11 plan over the objection of the committee of equity holders; the objections focused primarily on a settlement that provided damages to secured creditors on account of breaching the no-call provision. 439 B.R. 561 (Bankr. S.D.N.Y. 2010). Not only did Judge Gerber find the proposed settlement to be in the best interests of the estate and fair and equitable, as required to approve a settlement and approve the plan, *id*. at 594-95, he also provided a framework for how he would approach the matter on the merits, *id.* at 600. According to Judge Gerber, the first analysis would be whether the provision was enforceable under state law (similar to the starting point for the majority of cases) and then the analysis would focus on applicability of the no-call provision in bankruptcy (here, he highlights how he would have approached the bankruptcy issues differently than *Calpine II* and *Biloxi*). His bankruptcy analysis follows the following points:

- He appears to disagree with the "overly broad statement of the law", as stated in *Calpine II*, that "[B]ecause Debtor's bankruptcy filing rendered the no-call provision in the notes unenforceable and liability cannot be incurred pursuant to an unenforceable contractual provision, Debtor did not incur any liability for repaying the notes." *Id*. at 604.

- He questioned whether make-whole provisions and damages for breach were proxies for unmatured interest that are not allowed under the Bankruptcy Code (see discussion below).
- This point is tempered, however, with reference to *Biloxi's* discussion of the debtor's solvency and that unmatured interest may be allowed in cases with solvent debtors. *Id.* at 605.

Based on this analysis, Judge Gerber approved the settlements and confirmed the plan.

2. <u>Is the payment enforceable under state law</u>? *See School Specialty, Inc.*, 2013 WL 1838513 at *2 (Carey, J.) ("The inquiry into whether a prepayment provision will be enforced in bankruptcy begins with whether the prepayment provision is enforceable under applicable state law.").

Many states use the same rules that govern liquidated damages, which ask whether (i) actual damages would be difficult to calculate and (ii) whether the prepayment fee is not "plainly disproportionate" to the probable loss. *See School Specialty*, 2013 WL 1838513 at *3 (applying New York law).

The *School Specialty* court allowed enforcement of a 37% prepayment penalty because (i) the payment was tied to a reasonable expectation of future income streams (discounting future interest payments using a rate tied to Treasury note performance) and (ii) the lender had been required to act as though the loan was extended pursuant to the terms of the credit agreement, so it was permissible to apply the prepayment penalty to the entire amount of the available credit (as opposed to only the funds advanced).

The key state law question is whether the make-whole provision is tied to a reasonable expectation of the lender's losses. Well-drafted provisions should take into account tying make-whole provisions to the under-writing expectations. For example, the court in *In re VEC Farms, LLC*, 395 B.R. 674, 685 (Bankr. N.D. Cal. 2008) provided two examples under California law:

- <u>Unreasonable</u>: Trigger a pre-payment charge of six-months' interest upon a single late payment. *Citing Ridgley v. Topa Thrift & Loan Ass'n.*, 953 P.2d 484 (Cal. 1998).

- <u>Reasonable</u>: Tie damages under a partnership agreement to a multiple of the non-breaching partner's past income. *Citing Weber, Lipshie & Co. v. Christian*, 60 Cal. Rptr. 2d 677 (Cal. Ct. App. 1997).

Another view comes from *In re South Side House, LLC*, which described one way of satisfying the test under New York law as "an arms-length transaction between adequately represented sophisticated businessmen" because "it would be offensive to the basic notion of freedom of contract to allow the borrower to 'gamble with lenders' money regarding the discount rate applicable to pre-payment charges." 451 B.R. 248, 271 (Bankr. E.D.N.Y. 2011) (quoting *Fin. Center Assoc. of East Meadow v. TNE Funding Corp. (In re Fin. Center Assoc. of East Meadow*), 140 B.R. 829, 837-38 (Bankr. E.D.N.Y. 1992). Note that many states also require a showing that the prepayment was negotiated at arms' length. *See School Specialties*, 2013 WL 1838513 at *4.

3. Is the Make-Whole Provision Permitted Under the Bankruptcy Code?

Even if a make-whole provision would be enforceable under state law, there is potential that the Bankruptcy Code would not enforce the provision (as seen in the discussion of no-call provisions above).

One step in analyzing make-whole provisions under the Bankruptcy Code is determining whether they are an additional fee or if they serve as a stand-in for unmatured interest. Under 11 U.S.C. § 502(b)(2), claims for unmatured interest are not allowed. Although most courts view make-whole provisions as fees, *see Noonan v. Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R. 326, 330 (Bankr. E.D. Wis. 2000) ("[T]his court is in agreement with a majority of courts that view a prepayment charge as liquidated damages, not as unmatured . . . interest that would be disallowed under section 502(b)(2)"), the *Chemtura* court stated that, given the opportunity, it might embrace the minority view that "make-whole premiums and damages for breach of a no-call are proxies for unmatured interest—and that where unmatured interest must be disallowed, they likewise should be disallowed." 439 B.R. at 604.

Assuming that the court views the make-whole premium as a fee instead of a claim for unmatured interest, lenders may still need to deal with the requirements of 11 U.S.C. § 506(b), which could limit a secured creditor's claims for make-whole fees to reasonable fees, costs, or charges.[1] Most courts agree that, for pre-petition fees, the reasonableness standard of § 506(b) does not apply. *See School Specialty*, 2013 WL 1838513 at *4 (recognizing that the majority view is that 11 U.S.C. § 506(b) does not apply to amounts accruing prepetition).

For make-whole provisions that are triggered after the petition is filed, the reasonableness standard is often met simply by meeting the requirements of state law. *School Specialty*, 2013 WL 1838513 at *4; *In re Skyler Ridge*, 80 B.R. 500, 507 (Bankr. C.D. Cal. 1987) (noting the similarity between 506(b) and state law tests for liquidated damages).

Interestingly the court in *School Specialty* did not need to confront the reinstatement provisions of § 1124. In *School Specialty*, the term lenders (who were unwilling to consent to the use of cash collateral and who conditioned post-petition financing upon sale milestones) were refinanced by new lenders, and the amount of the make-whole was funded into an escrow (including carrying costs and litigation fees) pending attempts to litigate or settle the matter. Had the debtors instead obtained bridge financing (even on a subordinated basis from the eventual DIP lenders), it is conceivable that the debtors could have reinstated the term loans for the original duration and avoided the $23.7 million premium payable on account of the $70 million term loan. The ability of the plan proponents to reinstate the debt and avoid the make-whole may depend entirely on whether the premium was due automatically upon the commencement of the case or whether the lender had validly accelerated the loan pre-bankruptcy. Of course, the decision by the lender to accelerate the loan must be coupled with clear provisions that trigger the payment upon acceleration by the lender (as opposed to an action by the borrower to terminate early).

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[1] "To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose."

But what should a creditor do when faced with a pre-petition request by a borrower to provide emergency financing to enable the borrower to refinance its existing senior lenders who are otherwise threatening to foreclose and force a bankruptcy filing? The new lender does not want to have its expectations defeated by providing the rescue financing only to have its yield maintenance provisions challenged in a subsequent bankruptcy. Worse yet, the lender would not want to replace a pre-petition secured creditor only to have a subsequent bankruptcy case subject it to the risk of cram-down and a forced long-term restructuring. As a result, creditors must design these pre-petition rescue financing packages with up-front fees that are designed to create an incentive to be "rolled-up" into a DIP financing that cannot be crammed-down.

II. Recent Trends in Roll-ups

1. Roll-Ups Generally

Rolling up debt through DIP financing allows over-secured prepetition creditors to avoid cram-down under 11 U.S.C. § 1129(b). It is unlikely that a prepetition lender could obtain a court order that declared the prepetition lender immune from cram-down in exchange for the use of cash collateral or for incremental new money financing. Therefore, the technique is to "refinance" or "roll-up" the debt is used in order to replace the prepetition debt with post-petition debt.

The market for "roll-ups" has changed over the years. At first, they were used and then decried as illegal "cross-collateralization" where the under-secured prepetition lender was bootstrapping its inadequate collateral package into a fully secured DIP loan. Over time, courts and practitioners built in protections against the use of DIP financing to repay what is later determined to have been repayment of an under-secured creditor. However, despite a greater awareness of the dangers of roll-ups and the deprivation of the debtor's (and other plan proponents') use of the cram-down tool, roll-ups continue to be used. One reason is the relative ease to continue with the same prepetition lender or syndicate of lenders. Another reason is the bifurcation of secured debt into multiple tranches, where the "senior tranche" may be over-secured on a uncontested basis, thereby reducing one of the perceived perils of roll-ups.

In the past several years, roll-ups also have regained prominence due to the tight DIP financing market; few traditional lenders are willing to extend credit to debtors, creating opportunities for lenders already exposed to the debtors' risk or hedge funds looking to leverage unique funding ideas to extend postpetition credit. Furthermore, with the proliferation of second lien financing, split-lien financing and now unitranche financing, there are a number of pre-petition working capital structures that can be easily converted into a post-petition DIP loan through the use of a "roll-up" or refinancing of the asset-based, working capital component.

Some of the largest roll-ups on record have occurred in the past seven years:

- *In re Radioshack Corp*, Case No. 15-10197, Docket No. 947 (Bankr. D. Del. March 12, 2015) (approving $285 MM DIP financing that rolls up $250.3 MM in prepetition debt).
- *In re Constar Int'l Holdings LLC*, Case No. 13-13281, Docket No. 212 (Bankr. D. Del. Jan. 16, 2014) (approving $17.4 MM DIP financing that rolls up $2.9 MM in prepetition debt).

- *In re Lyondell Chemical Company*, Case No. 09-10023 (Bankr. S.D.N.Y. March 1, 2009) (approving $8 B modified DIP financing that rolls up $4.75 B in prepetition debt).

2. ABI Commission Reforms Would Dramatically Scale Back Roll-Ups

There has been significant pushback against these aggressive roll ups. In addition to the expected creditors' committee objections, the ABI Commission to Study the Reform of Chapter 11, in its Final Report and Recommendations (2014) suggested that:

> A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that --
> - The postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor, and provide more financing on better terms than alternative facilities offered to the debtor; and
> - The court finds that the proposed postpetition financing is in the best interests of the estate.

Note that clause (b) in the first point above contains two key components that the ABI Commission found more laudable for refinancings: substantial new credit and better terms than alternative facilities. In other words, if the prepetition lender is lending a lot more money or if the debtor gets an opportunity to maximize value through a sale process or a plan and the economic price tag for the new money is better than alternatives, then in that event the lender can also swap its prepetition debt for postpetition debt and avoid cram-down.

Adoption of the ABI Recommendations would drastically change postpetition financing. At what point does a lender extend substantial new credit? *In re Constar* (January 2014) approved DIP financing that was only 16.7% roll-up; *In re Radioshack* had DIP financing that was 87.8% rolled up prepetition debt (and 100% of the prepetition ABL). But the DIP in *Radioshack* still provided $30 MM in credit; is that substantial?

Judge Sontchi appears to have relied on the ratio of roll-up to new money in *In re Constar* when he approved DIP financing offered by Black Diamond (which had a .2-to-1 ratio of roll-up to new money) instead of Solus Alternative Asset Management (which offered a .4-to-1 ratio), even though the debtors initially preferred the Solus financing. *See* Case No. 13-13281, Docket No. 212 (Bankr. D. Del. Jan. 16, 2014).

The Commission also recommended not allowing liens on Chapter 5 actions and non-enforcement of intercreditor agreements that prevent junior creditors from offering postpetition financing. The overall goals of the recommendations were to encourage a robust and healthy postpetition financing market while trying to limit the opportunity for perceived abuse of Section 364 (which they identified as roll-ups where the "'new credit' extended by such facility may be nominal. . . . "). ABI Recommendations, p. 78. On the other hand, some waivers in intercreditor agreements often *prohibit* junior creditors from *objecting* to the use of cash collateral or DIP

financing to the extent consented to by the senior lenders, which often foster the consensual financing of the debtor's case. Apparently some waivers in intercreditor agreements are more salutary than others.

3. Gradual Roll-ups

Another continuing trend is gradual (or “creeping”) roll-ups: instead of offering a full replacement loan on day 1, postpetition lenders offer a revolving loan tied to repayment of the prepetition debt from collection of cash collateral and re-advancing an equivalent amount of funds under the DIP facility. In cases like *In re Karmaloop* (Bank. D. Del.) and *In re Boomerang Tube* (Bankr. D. Del.), gradually rolling up the prepetition debt allowed debtors to secure the consent of prepetition lenders (whose debt got converted into post-petition debt) while limiting the roll-up to what was actually needed by the debtor (protecting the interests of other creditors). Moreover, when DIP lenders are over-secured, the roll-up feature of the financing does little more than change the timing of the repayment, while maintaining the overall value of the estate.

Note that some gradual roll-ups do not actually offer new substantial amounts of incremental funding if they operate as envisioned by the lenders; under the ABI Recommendations, these types of post-petition financing deals likely would be barred.

4. Second Lien, Split-Lien and Unitranche Roll-Ups.

In a case with second lien financing, the first lien lenders who provide the incremental DIP financing may face substantially less objection from a creditors' committee (or the Court) in connection with a full or gradual roll-up given the likelihood that the first lien lenders are substantially over-secured. As such, there is significantly less concern that the roll-up is resulting in the repayment of an under-secured claim or that preserving the right to “cram down” the first lien lender is material. When the second lien lenders try to provide the refinancing of the first lien and second lien with a new DIP financing facility, traditional objections reappear.

Second lien structures have been increasingly replaced with “split lien” structures where the working capital lenders have a first lien on accounts and inventory and the term lenders are lending against enterprise value with a first lien on goodwill and other assets other than accounts and inventory. Each group of lenders typically has a second lien on the other lenders' collateral package. In bankruptcy, the debtor often needs both an increase in commitments from the working capital lenders (who may restrict funding based upon availability) and incremental financing from the term lenders. This often results in a “split lien” DIP financing where both groups provide new financing and are governed by a new intercreditor agreement. (*See In re Boomerang Tube*). These structures sometimes seek to roll-up only the working capital facility; others seek to roll-up both the working capital facility and portion of the term loans (if a term loan portion is undisputedly “in the money”); and others seek a full roll-up of the both facilities, drawing the same objections described above.

"Unitranche" structures are new and there is very little precedent for chapter 11 cases involving new DIP financing under unitranche structures. While *Radio Shack* has garnered a lot of attention for involving unitranche lenders, the "unitranche" structures in that case also involved a "split lien" such that the working capital lenders had a group of "first out" and "last out" working capital lenders under the working capital loan document; and the term lenders also had a group of "first out" and "last out" term lenders. In a more common unitranche structure, there is one credit agreement, one collateral agent and one lien. The lenders, by separate agreement, allocate which group is entitled to be repaid first (the "first out lenders") and which group comes later (the "second out" or "last out lenders"). For an example of a unitranche DIP financing, *see In re Pope & Talbot* (Bankr. D. Del. 2007) (DIP financing had one collateral agent and one lien, but specified the allocation of collateral proceeds between working capital lenders on the one hand and term lenders on the other).

There is little published precedent regarding unitranche DIP financings but the expectation is that they will follow the path of second-lien and split-lien financings. If the pre-petition lender group is unable to convince the court to allow for the "roll-up" of the entire pre-petition facility, then it is expected that the DIP lenders will provide for a "gradual roll-up" that results in the gradual repayment of the "first out" debt, with new money being funded under a DIP financing facility as the pre-petition facility reduces over time. The effect of the unitranche roll-up may be that the DIP lenders consist only of "first out" lenders under the pre-petition facility, though the side letter among lenders may allow the "last out" lenders to participate in the new money financing under the DIP (to earn fees, participate in case milestones, participate in the exercise of remedies, credit bidding and the like). If the last-out lenders participate in the DIP financing under a unitranche facility, there likely will be four strips of debt: first out and second out prepetition debt; and first out and second out post-petition debt. Whether the post-petition "second out" debt is structurally subordinated to the "first out" pre-petition debt may be an issue governed by private arrangement among the debt holders or it may be expressly set forth in the court order subordinating part of the new money DIP financing to a portion of the pre-petition facility.

III. Junior DIP Financing; "Sandwich" DIP Financing

Junior DIP financing has become more popular. For example, in *In re Loehmann's Holdings* cite (Bankr. S.D.N.Y.), Whippoorwill Associates supplied a $7 million DIP that was junior to $33 MM of senior debt. Likewise, in *In re Borders Group, Inc.* (Bankr. S.D.N.Y.) , the DIP included a $20 MM first-in, last-out tranche. *See also In re Boomerang and In re Simplexity* (Bankr. D. Del. 2013).

Often, junior DIP loans can offer flexibility for all the parties in interest: the lender is assured that it will get a minimum return on its DIP advance while other creditors can use § 506(c) to ensure that, if the DIP financing does nothing more than protect the DIP lender's prepetition position, those charges can be levied against the prepetition secured lenders, not the estate. (Though note that a substantially over-secured prepetition *first lien* lender should be immune from § 506(c); while the second lien lender, as the holder of the fulcrum security, may find its lien subject to attack).

As an example, consider an under-secured senior lender with a prepetition claim of $40MM who wants to advance postpetition financing. The liquidation value of the lender's collateral is

$30MM, but if a sale of the business as a going concern goes through, the lender believes its collateral could be worth $50MM. The lender wants to advance $5MM to keep the business operating and to support the sale.

If the $5MM is advanced as regular senior DIP financing, the lender likely is not in a better position if the sale falls through: its $5MM in postpetition financing will be paid out of the liquidation value of the collateral, leaving it with only $25MM in collateral value for its prepetition claim. This leaves the lender in a worse position than if it had not advanced postpetition financing.

However, imagine a junior DIP: the postpetition financing is junior to $30MM of the prepetition claim. That way, if the sale falls through, the lender is left with a $5MM claim for the postpetition financing while its prepetition claim still has the benefit of the full $30MM value of its collateral. This puts the secured creditor in a better position than a traditional DIP loan.

Yet other creditors still have recourse against the DIP lender: if the $5MM only benefits the DIP lender in its capacity as a prepetition secured creditor and the $5MM is deemed to be the costs incurred in connection with preserving or disposing of the collateral, then the pre-petition creditor's collateral can be surcharged to repay the $5MM DIP financing via §506(c). Although establishing grounds for a surcharge can be difficult, *see In re TIC Memphis RI 13 LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013), if the pre-petition lender is seeking to provide a DIP financing on a junior basis, the creditors' committee would be well-advised to object to any § 506 (c) waiver set forth in the order approving DIP financing. In the context of a junior DIP provided by the prepetition secured lender, this use of § 506(c) is consistent with the ABI recommendation against blanket waivers of surcharges.

In addition, a junior DIP provided by a third party could also be considered as a more viable alternative if joined with an attempt to not prime the entire pre-petition secured claim. If the pre-petition senior lender owed $50MM is not willing to provide new financing, but whose collateral is only worth $30MM absent additional funding, an argument can be made that the new DIP financing should rank junior to the first $30MM but senior to the $20MM additional pre-petition claim. *See generally* Kenneth Ayotte and David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. Chi. L. Rev. 1557, 1605-06, n. 111 (2013)("A less aggressive approach in this case, consistent with our limited-seniority solution, would be to allow the DIP loan to prime the existing lender only to the extent of the new value created by continuation).

The Commercial Finance Association ("CFA"), when asked by the ABI to provide recommendations for the reform of chapter 11, urged the ABI to do away with § 364(d) "first dollar" priming and replace it with a "sandwich DIP" tied to the realizable value of the collateral. As suggested by the CFA:

> "CFA believes that one of the more inefficient provisions of the Code is the threat of a "priming" lien that could in theory trump the secured creditor and result in a secured creditor receiving less than its state law entitlements. CFA is aware that prominent practitioners have advocated the loosening of 364 "priming" standards as the single most important subject for reform from the debtor's perspective. CFA is opposed to any such change and submits that it would have an immediate adverse impact on the availability and cost of credit. On the other hand, alternative approaches could have the opposite

> effect. For example, if secured creditors had the assurance of maintaining the priority of their liens up to the value of their interest in the collateral (measured, as discussed elsewhere in this paper, based upon the realizable value of the collateral under the circumstances taking into account any limitation on the consensual use of cash collateral or incremental financing to be provided by the secured creditor), new sources of DIP financing could become available without the risks and expenses created by the present system for obtaining priming loans. For example, if the creditor's claim of $50 is secured by collateral then worth $35 without new investment, but worth $60 to $75 with an incremental $25 of investment, it probably would be difficult to convince the existing secured creditor (particularly a regulated bank) to increase its investment to $75 only to recover $75. However, if the secured creditor is assured a first lien of $35 (plus interest), the creditor may be more likely to consent to an additional $25 junior to its $35 and senior to its remaining $15....CFA believes that this modified DIP financing approach would be preferable to existing law because it gives the secured creditor the assurance that it would retain its secured claim in much the same manner (i.e., via judicial valuation) as its secured claim is preserved under a plan, and thereby encourages secured creditors to invest additional funds in debtor companies."

See First Report of the Commercial Finance Association to the ABI Commission to Study Reform of Chapter 11, http://wvvw.cfa.com/ABI.pdf.

Unfortunately for secured lenders, the ABI Commission went in the opposite direction of the CFA proposal and recommended the loosening of standards to prime prepetition secured creditors. Much has been written on the flawed presumptions about the need for such drastic reforms and whether the new proposals, if considered, would have the effect of making prepetition loans more expensive and create more uncertainty and litigation in the event of bankruptcy. *See The Trouble With Unneeded Bankruptcy Reform*: The LSTA's Response to the ABI Chapter 11 Commission Report (Oct. 2015) at pp.53-57[2]. *See also* Randall Klein and Prisca Kim, *ABI Bankruptcy Reform: Will It Destroy Cash Flow Lending*?, The Bankruptcy Strategist (April 2015).

[2] http://vvww.lsta.org/uploads/DocumentMode1/1860/file/lsta-abi-10615-final.pdf