

Can you roll-up?



What every prepetition lender should know about postpossession financing

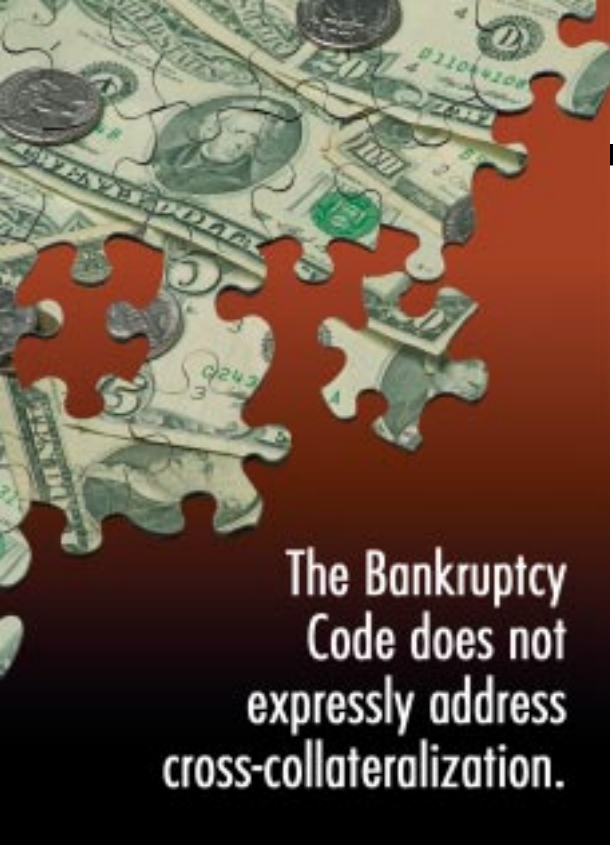
by Inez M. Markovich

In today's economic climate marked with an almost unprecedented number of large corporate bankruptcy filings, more and more secured lenders are facing the decision of whether to extend credit to a debtor-in-possession and, if such decision appears prudent, what is the most sensible structure for such debtor-in-possession financing. The debtor's reason for seeking debtor-in-possession financing (or DIP financing) is obvious: without adequate financing, the debtor cannot continue normal business operations. The Bankruptcy Code contemplates that the debtor's postpetition financing may come from two sources: authorization to use cash collateral under § 363(c) and authorization to obtain DIP financing under § 364. In many cases, the debtor's ability to use cash collateral in its postpetition operations may be limited. Hence, the success of the debtor's reorganization case depends on its access to postpetition financing. Unlike debtors, secured lenders may decide to lend money to a distressed company for a variety of reasons. Being free of the vulnerability of prepetition creditors with an interest in cash collateral, various unrelated lenders, ranging from traditional syndicated lenders to

high-risk funds, find lucrative investment opportunities on the market for postpetition financing. On the other hand, to prepetition lenders, DIP financing often offers an opportunity to protect or even enhance their prepetition position. Prepetition lenders' common conditions for extending credit to a debtor-in-possession often include: cross-collateralization; waivers of various claims and defenses against the lenders (such as preference and fraudulent transfers; lender liability claims; challenges to the validity and/or perfection of the lender's liens); "drop dead" provisions allowing the lender to proceed against the collateral without obtaining relief from the automatic stay; an asset liquidation schedule that requires the debtor to sell its assets, thereby eliminating some of the debtor's reorganization options, and requiring multiple debtors or nondebtor affiliates to assume liability for and pledge their assets to secure the DIP loan.

One provision often implemented by prepetition lenders that provide postpetition financing is the so-called "roll-up," which, together with certain other protective

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The Bankruptcy Code does not expressly address cross-collateralization.

ups,” in order to be able to successfully implement this effective provision.

Bankruptcy Code framework for DIP financing

Designed to encourage creditors to lend money to distressed companies, the statutory framework for postpetition financing is very straightforward. The debtor may obtain unsecured ordinary course credit without court approval under § 364(a). The court, after notice and a hearing, may authorize the debtor to incur unsecured nonordinary course credit with an administrative expense status under § 364(b). If the debtor is unable to obtain unsecured credit pursuant to § 364(b), then § 364(c) authorizes the debtor, with court approval, to obtain postpetition credit with an administrative priority status with priority over all other administrative expense claims, or secured by a lien on the debtor’s unencumbered assets or a junior security interest in its encumbered assets. Finally, if the debtor’s efforts to obtain secured credit in accordance with the provisions of § 364(c) fail, then, under § 364(d), the court may authorize the debtor to obtain postpetition financing secured by a lien that is senior to the prepetition liens on the debtor’s assets, also known as the “priming” lien. In order to grant “priming” liens, the debtor must demonstrate not only that it has failed to obtain credit otherwise, but also that the security interests of the prepetition lenders will be adequately protected in case the “priming” liens are granted. *See Tenney Village Company, Inc.*, 104 B.R. 562 (Bankr. D. N.H. 1989).

Cross-collateralization provisions

In cases where the DIP lender also holds prepetition claims against the debtor, the DIP lender will often try to cross-collateralize its prepetition loans and postpetition loans so

measures, often becomes subject to objections by the creditors’ committees and U.S. Trustees. Prepetition lenders must have a good understanding of the different varieties of “roll-up” provisions, as well as the existing legal environment governing the use of “roll-

that the prepetition claims will be secured with the collateral pledged postpetition. Such structure becomes especially powerful in the case of an undersecured creditor who will convert its undersecured prepetition claim into a fully secured postpetition one.

Vanguard standard for approval of cross-collateralization in limited circumstances: The Bankruptcy Code does not expressly address cross-collateralization. However, because cross-collateralized financing structures allow prepetition creditors to bypass the priority scheme contemplated in the Bankruptcy Code, courts consider this measure to be controversial. In fact, courts are split on the issue of the permissibility of cross-collateralization clauses. For instance, some courts, particularly courts within the Fifth and Second Circuits, while stressing that cross-collateralization is a controversial and rather disfavored means of DIP financing, approve of such arrangements in certain circumstances. *See In re Babcox & Wilcox Co.*, 250 F.3d 955 (5th Cir. 2001); *Official Committee of Unsecured Creditors v. Goold Electronics Corp.*, No. 93 C 4196, 1993 U.S. Dist. LEXIS 14318 (Bankr. N.D. Ill. 1993).

The courts that approve cross-collateralization seek to balance the debtor’s needs for funding with the rights of its creditors. Thus, in order to obtain court approval of a cross-collateralized scheme, the debtor is required to show that (1) the debtor’s business operations would fail without the proposed financing; (2) the debtor is unable to obtain financing from an alternative source on more conventional terms; (3) the lender will not provide the necessary funding unless on the proposed terms; and (4) the proposed financing agreement is in the best interests of the estate and its creditors. *See Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983); *See also, Goold Electronics Corp., id.* (citations omitted).

Rejection of cross-collateralization under Saybrook: In contrast, the Eleventh Circuit has held that cross-collateralization provisions are a *per se* impermissible means of obtaining postpetition financing because such clauses contravene the priority scheme of the Bankruptcy Code. *See Shapiro v. Saybrook Manufacturing Co., Inc. (In re Saybrook Manufacturing Co., Inc.)*, 963 F.2d 1490, 1494-95 (11th Cir. 1992). Those parties that typically oppose postpetition financing proposed to be made by prepetition lender, such as creditors’ committees and U.S. Trustees, often rely on the *Saybrook* reasoning in support of their objection to the proposed financing.

Roll-up structures

In light of the controversial nature of cross-collateralization, roll-up financing has recently emerged as a viable alternative to cross-collateralization. There are virtually no judicial opinions addressing the enforceability of roll-up structures in general or any particular forms of

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roll-up financing. Therefore, in structuring, documenting and obtaining court approval of a roll-up DIP credit facility, lenders and their legal professionals quite often have no guidelines other than their own experiences from other bankruptcies. Roll-up, or rollover, financing is an arrangement that allows secured lenders to convert their prepetition debt into postpetition debt. Roll-up financing is usually offered on a secured basis, with a super-priority administrative expense status. In the most basic roll-up structure, in addition to the new funding advanced to finance the debtor's operating needs, the postpetition facility will also contain a loan that will be applied to pay off the prepetition loans on the disbursement date.

In a revolving credit scenario, the roll-up financing may be structured in a way that requires the debtor, for each dollar of postpetition funding, to apply a dollar of the proceeds of collateral sales first to the repayment of the prepetition loans until the prepetition loans are fully "rolled" into the postpetition facility. This type of roll-up structure is sometimes referred to as a "creeping" roll-up. Proponents of this type of roll-up financing often distinguish it from cross-collateralization by stressing that in this type of postpetition facility, the postpetition debt is reduced through sales of the collateral securing the prepetition loans.

Advantages of roll-up structures

One of the obvious advantages of structuring a DIP loan as a roll-up is that roll-up financing appears to be a more subtle form of cross-collateralization and, therefore, is more likely to warrant court approval. Nonetheless, a secured lender should be mindful that if the prepetition loan is undersecured, then the use of postpetition loan proceeds, or proceeds of postpetition collateral sales, to pay off the prepetition

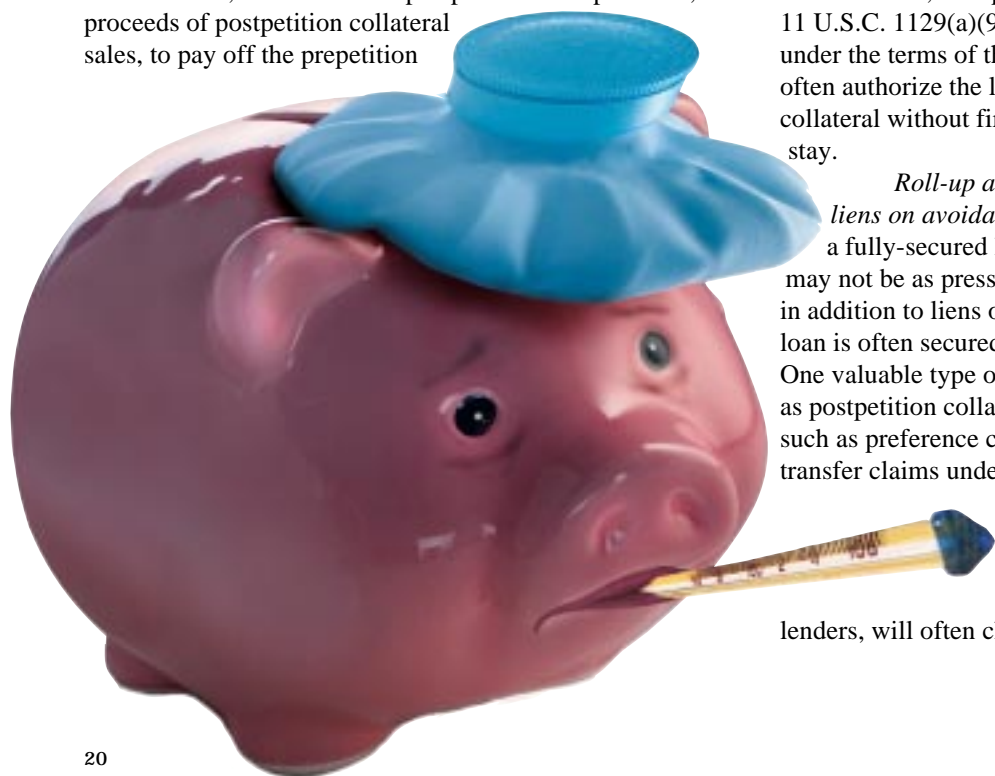
loan raises the same concerns of priority violations as cross-collateralization in its pure form.

Roll-up is a more permissible form of cross-collateralization: A fully secured prepetition lender does not need to provide a DIP credit facility in order to improve its collateral position. Nevertheless, even a fully secured lender can significantly advance its position in the debtor's bankruptcy case by providing roll-up DIP financing. First, in cases where the prepetition loan is fully secured, paying it off with the proceeds of the postpetition loan, or with proceeds of collateral sales, does not violate the distribution priority scheme of the Bankruptcy Code and, therefore, is more likely to receive the court's blessing.

Roll-up gives lenders more leverage in bankruptcy: More importantly, however, without the roll-up, the lender's rights in the collateral would be subject to the automatic stay, the prepetition claim would be paid under the plan of reorganization, interest on the prepetition claim would continue to accrue only to the extent of the equity cushion, and the lender would be entitled to cash payments and/or additional liens only as adequate protection. Finally, at the plan confirmation juncture, the debtor may "cramdown" the lender's prepetition claim under § 1129(b)(2) by modifying the interest rate or repayment terms over the lender's objection.

A roll-up not only assures the immediate repayment of the prepetition claim, but also provides the secured lender with additional leverage that it would not otherwise be entitled to under the Bankruptcy Code. Thus, because the postpetition debt has a postpetition administrative expense status, unless the lender otherwise agrees, the postpetition debt must be paid in full in cash on the plan's effective date, thus preventing a potential cramdown. *See* 11 U.S.C. 1129(a)(9)(B). In the event the debtor defaults under the terms of the DIP credit facility, the DIP order will often authorize the lender to proceed after the postpetition collateral without first obtaining relief from the automatic stay.

Roll-up allows to secure lenders' claims with liens on avoidance claims: Although, as stated above, a fully-secured lender's need for additional collateral may not be as pressing as that of an undersecured lender, in addition to liens on the existing assets, a postpetition loan is often secured with liens on unencumbered assets. One valuable type of asset that can be, and often is, pledged as postpetition collateral are the estate's avoidance claims, such as preference claims under § 547 and fraudulent transfer claims under §§ 548 and 544(b) of the Bankruptcy Code. Lenders should be aware that creditors' committees, a constituency whose interests are often diametrically opposed to that of the DIP lenders, will often challenge a proposed DIP loan facility



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on the ground that it is secured with a pledge of the estate's recoveries in avoidance actions. Undoubtedly, in the case of a roll-up, if the postpetition loan is secured, in addition to the liens on the existing collateral, by a lien on the avoidance actions' recoveries, the lender has effectively substituted its prepetition claim with a better collateralized postpetition one. Although in certain cases a DIP lender may determine that it is in its interest to give up a lien on the recoveries in avoidance actions in order to avoid a stand-off with the creditors' committee, several recent bankruptcy cases demonstrate that where there is no alternative DIP financing and the lender will not otherwise lend money to the debtor, courts are willing to allow the debtor to pledge recoveries in avoidance actions as collateral for the DIP loan. *Compare Murphy Marine Services, Inc.*, Case Nos. 01-00926 through 01-00950 (Bankr. D. Del.) (January, 2002 DIP order in favor of Wells Fargo Business Credit, Inc. allows pledge of recoveries in avoidance power claims) with *Kmart Corporation*, Case No. 02B2474 (Bankr. N.D. Ill.) (DIP order excludes avoidance actions from DIP collateral).

Dealing with challenges to roll-up DIP financing

A postpetition lender has a greater chance of securing court approval of a proposed roll-up financing facility if the proposed facility appears to be in the best interests of the debtor, its estate and its creditors, as opposed to merely allowing the lender to strengthen its collateral position and avoid the Bankruptcy Code's restrictions on the lender's nonbankruptcy rights. The author's experiences in three cases currently pending in the country's leading bankruptcy jurisdictions (Delaware, Chicago and New York) demonstrate that courts will authorize a financing structure where the balance is tipped in favor of the lender so long as the overall effect of the proposed facility appears to benefit the debtor by providing a meaningful infusion of new funding in the debtor's operations. The lender and the debtor can further streamline the DIP financing approval by negotiating with the unsecured creditors' committee to resolve any concerns prior to seeking the bankruptcy court's approval of the proposed facility.

Lenders fail to obtain approval of a roll-up in Murphy Marine Services, Inc.: *Murphy Marine Services* is a case in which the DIP lender did not succeed in procuring the court's approval of a DIP credit facility that contained a

roll-up structure. *Murphy Marine*, its parent, *The Holt Group, Inc.*, and their various affiliates involved in the business of cargo transportation and logistics, sought bankruptcy protection by commencing 25 separate Chapter 11 cases in the Bankruptcy Court for the District of Delaware on March 21, 2001. *See Murphy Marine Services, Inc.*, et al, Case Nos. 01-00926 through 01-00950. The prepetition lenders, comprised of First Union National Bank, Fleet National Bank, Wilmington Trust of Pennsylvania, and MBC Leasing Corp., and headed by First Union, agreed to provide a postpetition facility consisting of a \$10,000,000 revolving facility to be used by the debtors in their postpetition operations and a \$62,515,905.61 term loan to be used to pay off in full the debtors' prepetition debt to the bank group. The interim order authorized postpetition funding in an amount up to \$3,500,000.

The debtors' motion to approve the proposed DIP financing on a final basis met strong opposition from the official committee of unsecured creditors, as well as some of the debtors' other secured creditors, such as PNC Bank, N.A., and BTM Capital Corporation. Among the grounds for objection to the entry of a final order approving the terms of the DIP credit, the creditors' committee stressed that the roll-up structure was in the nature of impermissible cross-collateralization, as the lenders sought to convert \$62,515,905.61 of prepetition debt into postpetition, super-priority debt, secured with liens on all or substantially all of the debtors' assets, while committing to provide only \$3,500,000 of new funding.¹

The bank group was unable to overcome the committee's objection to the proposed roll-up, as a result of which, the final DIP order did not contain any roll-up terms, merely authorizing the lenders to advance up to \$10,000,000 to the debtors. *See Murphy Marine*, Final DIP Order of July 12, 2001. Although the lenders possibly achieved a partial reduction of the prepetition debt through sales, outside of the ordinary course of business, of some of the debtor's assets, they nevertheless stopped short of achieving their objective of obtaining super-priority status for the entire amount of their prepetition claims. One may argue that instead of structuring the roll-up as a term loan for the repayment of the prepetition debt, the lenders should have structured the roll-up as a "creeping" roll-up with a higher postpetition borrowing limit, thus preventing the creditors' committee's argument that the amount of new financing was disproportionately small to justify the roll-up of the prepetition debt.

Lenders succeed in obtaining court approval of roll-up financing in Venture Lighting International, Inc., and Covanta Energy Corporation: In contrast to *Murphy Marine*, *Venture Lighting* is an example of the postpetition lenders' successful implementation of a roll-up provision in

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the DIP financing terms. Venture Lighting International, Inc., a manufacturer of metal halide lighting products, together with six of its affiliates, commenced a Chapter 11 case in the Northern District of Illinois on February 5, 2003. The prepetition bank group, consisting of PNC Bank, N.A., National City Commercial Finance, Inc., and Sovereign Bank, and led by PNC, proposed to make a postpetition revolving facility in the maximum principal amount approximately equal to the lenders' prepetition claims. The terms of the proposed DIP financing provided that the postpetition loans would be secured by a first-priority lien on the debtors' unencumbered assets (including the recoveries in avoidance actions) and a lien junior in priority to the existing liens on all other assets, and that the proceeds of postpetition sales of the lenders' prepetition collateral and cash collateral would be applied first to payment in full of the prepetition indebtedness and then, to the extent available, to payment of the postpetition indebtedness.

The official committee of unsecured creditors objected to the roll-up structure of the proposed financing, arguing that, by "replacing" the prepetition debt with a "new" postpetition loan, the DIP lenders in effect sought to cross-collateralize their prepetition claims with postpetition collateral, in violation of the priority scheme of the Bankruptcy Code. However, by choosing to use the revolving roll-up structure, as opposed to making a term loan for the purpose of repayment of the prepetition indebtedness, the DIP lenders made the entire amount of the postpetition credit available to the debtors in their postpetition operations, thus making the proposed financing terms appear more reasonable than the proposed financing in *Murphy Marine*. Further, in order to successfully defeat the motion to approve the proposed DIP financing, the committee would be required to show that the debtors had access to alternative financing on less onerous terms. While the lenders did not take a priming lien on the debtors' encumbered assets, it is unlikely that an unrelated lender would provide DIP financing to the debtors unless permitted to prime the prepetition liens, which would in turn require the debtors to adequately protect the prepetition lenders' interests in the collateral. The bankruptcy court, by Judge Squires, approved the proposed DIP financing on a final basis over the committee's objection, without changing a single proposed term of the DIP financing. See *Venture Lighting*, DIP Order, March 13, 2003.

Finally, in *Ogden New York Services, Inc., et al*, the Chapter 11 cases commenced in the Southern District of New York by a major energy provider, Covanta Energy Corporation, and its affiliates. The debtors successfully



procured a postpetition financing facility in the aggregate amount of \$289,062,730.13 from a bank group led by Bank of America, N.A. The terms of the DIP facility, approved by Judge Blackshear, provided for a \$48,200,000 sublimit to be used to finance the debtors' cash needs and the issuance of new letters of credit and, in a roll-up variation, a

\$240,862,730.13 sublimit to replace the outstanding letters of credit issued by the same bank group prepetition. See *Ogden*, DIP Order, May 15, 2002. This facility was instrumental in supporting the debtors' cash needs and ensuring the continuation of the letters of credit supporting the performance and payment obligations of the debtors' energy and water facilities. It is noteworthy that in addition to securing the DIP facility with first priority liens on unencumbered assets and liens junior in priority to the existing liens, the court approved, pursuant to § 364(d), the grant of superpriority, priming liens on the debtors' assets that constituted the prepetition collateral of the DIP lenders.

Conclusion

In light of the current economic outlook, it is unlikely that new large corporate bankruptcy filings will drastically decline in the near future. By advancing postpetition financing to the debtor-in-possession, a prepetition lender can not only improve the debtor's chances of reorganizing its business, but can also significantly advance the position of its prepetition claims in the bankruptcy case. As demonstrated in this article, the likelihood of the court's approval of a proposed DIP financing structured as a roll-up often depends on the reasonableness of the proposed roll-up structure, the lender's prepetition collateral position, availability of alternative financing and, sometimes, the success of the lender's and debtor's negotiations with the creditors' committee and other creditor constituencies.

Endnotes

- ¹ The committee also argued that the amount of postpetition funding provided by the bank group was insufficient to support the debtors' postpetition cash needs and the terms of the DIP loans restricted the debtors' ability to seek financing from other sources, including take-out financing. PNC and BTM argued that the bank group impermissibly sought to secure the postpetition facilities with a first priority lien on all of the debtors' unencumbered assets, including the assets of those debtors that did not benefit from the extension of the postpetition credit.



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