GOVERNMENT GUARANTIES FOR CORPORATE BANKRUPTCIES

Jonathan C. Gordon[*†]

ABSTRACT

The bankruptcy system has a problem. When a business files for Chapter 11 bankruptcy protection, a fundamental theory is that the business remains in control of its operations. This theory, however, has eroded in practice; the business is often forced to relinquish substantial control to the lender that helps finance the bankruptcy.

This Article proposes a solution: the federal government should help finance businesses as they restructure under Chapter 11 by guaranteeing their bankruptcy loans. With these guaranties, lenders would be less aggressive and more flexible with the loan provisions. Most notably, this Article is the first to provide a structural framework for such a government guaranty program.

ABSTRACT 251
INTRODUCTION 252
I. IN THEORY: THE DEBTOR IN POSSESSION SHOULD HAVE CONTROL 255
A. General Overview of Corporate Bankruptcy 256
B. Chapter 11 Fiduciary: The Debtor in Possession 259
1. Legislative History 259
2. Rationale 263
II. IN PRACTICE: THE DIP LENDER HAS CONTROL 267
A. Section 364: Obtaining Credit 268
1. Administrative With No Lien 270
2. Super-Priority Administrative With A Non-Priming Lien 271
3. Super-Priority Administrative With A Priming Lien 272
B. DIP Loan Provisions That Shift Control 273
1. Forum Shopping 274
2. Management 275
3. Contracts and Leases 275
4. Asset Sales 276
5. Plan of Reorganization 278
C. The Great Recession 280

---

* Independent. J.D. cum laude, Northwestern University (2018); B.B.A. cum laude, University of Notre Dame (2015).

† Special thanks to James Lindgren, Bruce Markell, and the Legal Scholarship Workshop at Northwestern University for helpful feedback. Additional thanks to Allyson Moore, Noah Greenstein, Ian Oxenham, Cydnee Bence, Danielle Bradtmiller, Gordanna Clevenger, Ryan Mitchell, Adam Mittemaier, Megan Noonan, Sarah Puzzo, and Bethany Towne for valuable editing.

1. Before the Recession 280
2. During the Recession 282
3. After the Recession 284
III. A SOLUTION: GOVERNMENT GUARANTIES 287
A. A Framework for Government Guaranties 288
1. Eligibility 289
2. Guaranty Limit 290
3. Guaranty Fee 290
4. Partnership 291
5. Disclosure 293
6. Maturity 293
7. Interest Rate 294
8. Priority 296
9. Collateral 297
10. Covenants and Conditions 298
B. The Benefits of Government Guaranties 300
CONCLUSION 304

INTRODUCTION

Operating a business is not easy—especially when the business is financially distressed. At that point, the business may wish to file for Chapter 11 bankruptcy protection under Title 11 of the United States Code (Bankruptcy Code).[1] Chapter 11 bankruptcy provides the business with an opportunity to restructure its debts, reorganize its operations, and

1. 11 U.S.C. § 101(32)(A) defines "insolven[cy]" as the "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32) (2012). Insolvency, though typically the motivation for bankruptcy, is not a requirement to file for Chapter 11. Section 109(d) lists the eligibility requirements for an entity to file for Chapter 11 relief; it does not list insolvency. *See id.* § 109(a), (d). Section 109(d) states:

> Only a railroad, a person that may be a debtor under chapter 7 of this title (except a stockbroker or commodity broker) [insolvency is not a requirement for chapter 7 either], and an uninsured State member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may [file for a Chapter 11 bankruptcy].

Id. § 109(d).

(hopefully) become solvent.[2] A bankruptcy judge oversees the reorganization, and the court must approve all major decisions.[3] A fundamental theory of Chapter 11 bankruptcy is that the debtor—and not a trustee—continues to control the business.[4] Indeed, the debtor is called a debtor in possession during bankruptcy because the debtor remains *in possession* of the business.[5]

Chapter 11, however, is expensive—and thus ironic.[6] An insolvent debtor, likely with insufficient cash already, now needs extra cash to take

---

2. *See id.* § 1101(1) (authorizing a debtor to be its own trustee in its Chapter 11 case); *id.* § 1108 (allowing a trustee to operate a debtor's business); *id.* § 1121(a) (allowing a debtor to file a plan of reorganization at any time); *id.* § 1123(a)(5)(A)–(J) (explaining what a plan of reorganization requires); *id.* § 1129(a)(11) (requiring that a plan of reorganization be confirmed only if it is unlikely to be followed by liquidation or further reorganization); *id.* § 1141(c) (declaring that upon confirmation of a reorganization plan, the debtor's property "is free and clear of all claims and interests of creditors" except as provided for in the plan); *see also* ELIZABETH WARREN, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES: ESSENTIALS 14–15 (2008) [hereinafter WARREN, REORGANIZING AMERICAN BUSINESSES] (explaining how Chapter 11 allows businesses a chance to restructure and possibly make their way out of debt as a functioning business). For a court to confirm a debtor's reorganization plan, the debtor must show that another reorganization is not likely to follow confirmation. 11 U.S.C. § 1129(a)(11). Nonetheless, some debtors inevitably return to Chapter 11 after a confirmation plan. *See, e.g.*, Taylor Harrison, *RadioShack's Bankruptcy Shows Why 'Chapter 22' Is The Hottest 2017 Retail Trend*, FORBES (Mar. 17, 2017), https://www.forbes.com/sites/debtwire/2017/03/17/radioshacks-bankruptcy-shows-why-chapter-22-is-the-hottest-2017-retail-trend/#4839c724292f (describing a trend of second bankruptcies in the retail industry); *see also* Jessica DiNapoli, *'Chapter 22' Looms Over Some U.S. Oil and Gas Bankruptcy Survivors*, REUTERS (Nov. 23, 2016), https://www.reuters.com/article/us-usa-energy-chapter22-analysis/chapter-22-looms-over-some-u-s-oil-and-gas-bankruptcy-survivors-idUSKBN13I0CG (identifying the potential for a similar trend in the oil and gas industry).

3. 11 U.S.C. § 327(a) (requiring court approval to employ professionals); *id.* § 363 (requiring court approval to sell, use, or lease property); *id.* § 364 (requiring court approval to obtain credit); *id.* § 365(a) (requiring court approval to assume or reject contracts and leases); *id.* § 1129 (requiring court approval of reorganization plan).

4. *See infra* Part I (discussing why a debtor should remain in control of a business even after filing for Chapter 11 bankruptcy). The court, however, appoints a trustee to control the business in cases of fraud, dishonesty, incompetence, gross mismanagement, or if a trustee would be in the interests of creditors, equity holders, and the estate. 11 U.S.C. § 1104(a).

5. 11 U.S.C. § 1101(1) (defining a "debtor in possession" as a "debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case").

6. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 68 ("For nearly all businesses in Chapter 11, the most pressing need is for operating capital."). Throughout a Chapter 11 reorganization, creditors (such as suppliers) are more likely to demand cash payments instead of extending lines of credit because the bankruptcy filing makes them worry about repayment. *Id.* at 69 ("[U]neasy suppliers that once extended credit now demand cash payments, and lines of credit and other financing arrangements quickly dry up . . . ."). Further, the debtor in possession must continue to pay operating expenses such as critical vendors and employees in order to operate effectively. *Id.* at 68–69; COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 89, 92 (2014) [hereinafter FINAL REPORT]. The debtor in possession must also pay fees and expenses to its lawyers and other professionals helping with the reorganization. *See* Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMPIRICAL LEGAL STUD. 111, 141 (2004) (reporting studies that suggest

advantage of bankruptcy's benefits.[7] Debtors in possession therefore often must borrow money from lenders such as banks and investment funds to operate throughout Chapter 11 bankruptcies.[8] This need for capital results in a multi-billion-dollar financing industry where debtors in possession borrow money from such lenders.[9] These loans are commonly referred to as DIP loans.[10]

In these DIP loans, the lenders often strip important control rights from the debtors in possession by imposing unfavorable terms in the loan agreements.[11] For example, the lender may require the debtor in possession to file in a certain venue,[12] to hire or fire certain management,[13] or to assume or reject certain contracts.[14] The list goes on. To be clear, it is in the lenders' best interests to exert control, and there is nothing inherently wrong with doing so. But aggressive loan provisions limit a debtor in possession's control, which is a fundamental policy of corporate bankruptcy.[15] And as a result, the whole bankruptcy estate suffers.[16]

---

professional fees and expenses for large public companies range "from about 1 percent to 3 percent of the value of the company's assets at bankruptcy").

7. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 69 ("[T]he need for cash after filing a Chapter 11 petition is often greater than it was beforehand.").

8. *See, e.g.*, Press Release, Toys "R" Us, Inc., Toys "R" Us, Inc. Closes $3.1 Billion Financing (Sep. 25, 2017), http://www.prnewswire.com/news-releases/toysrus-inc-closes-31-billion-financing-facilities-300525360.html (announcing a deal to borrow operating funds from a JPMorgan-led bank syndicate and prepetition lenders).

9. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, PRAC. L. FIN. 1, 3 (Feb. 19, 2015), https://www.davispolk.com/files/kenstein.chrobert.practical.law_.finance.article.03.24.15.PDF (listing total volumes of DIP financing at $13 billion of DIP loans in 2007, $18 billion in 2008, $62 billion in 2009, $15.5 billion in 2010, and $11.3 billion in 2014).

10. *See, e.g.*, David A. Skeel, Jr., *The Past, Present, and Future of Debtor-In-Possession Financing*, 25 CARDOZO L. REV. 1905, 1906 (2004) [hereinafter Skeel, *Debtor-In-Possession*] (referring to such loans as "DIP loans").

11. *See infra* Part II.B (detailing tactics used by DIP lenders to assert control over debtor's business).

12. *See infra* Part II.B.1 (discussing why and how DIP lenders control the venue in which debtors file for bankruptcy).

13. *See infra* Part II.B.2 (discussing ways that DIP lenders influence management decisions in a debtor's business).

14. *See infra* Part II.B.3 (explaining DIP lender authority regarding contracts).

15. *See* Jodie A. Kirshner, *Design Flaws in the Bankruptcy Regime: Lessons from the U.K. for Preventing a Resurgent Creditors' Race in the U.S.*, 17 U. PA. J. BUS. L. 527, 528–29 (2015) (discussing how secured creditors use aggressive loan terms to exert greater control than bankruptcy policymakers want).

16. As the rest of the Article will discuss, the most efficient reorganization occurs when control remains with the debtor, in part because of the management's familiarity with the debtor's business. *See infra* Part I.B.2 (discussing the policy rationale for letting debtors remain in control of business operations). Anything that strips substantial control away from the debtor in possession thus decreases the chances of a successful reorganization, and an unsuccessful reorganization harms the whole bankruptcy estate. *See* H.R. REP. NO. 95-595, at 233 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192

The practical consequences of DIP loans thus contradict the theoretical structure of Chapter 11. In theory, the debtor in possession should remain in control of the business and its reorganization.[17] But in practice, the debtor in possession must often relinquish substantial control to the DIP lender.[18] The current state of the bankruptcy system is thus problematic.

This Article proposes a solution: the federal government should help finance debtors in possession as they restructure under Chapter 11. Specifically, the government should guarantee the debtor's DIP loans, just as the government guarantees small business loans through its Small Business Administration (SBA) Loan Program.

Most notably, this Article is the first to provide a comprehensive framework for a federal DIP loan program. Specifically, this Article lays out a ten-element framework that the government could implement to guarantee DIP loans. Such a framework would realign bankruptcy practice with theory, generate economic benefits for the government, and preserve valuable jobs for society.

This Article proceeds in three parts. Part I discusses Chapter 11 and its fundamental theory that the debtor in possession should control the restructuring. Part II examines how today's practices have diverged from that theory. Part III proposes the solution of government guaranties and examines the government's SBA Loan Program as a potential framework to mirror.

I. IN THEORY: THE DEBTOR IN POSSESSION SHOULD HAVE CONTROL

"In fact, very often the creditors will be benefited by continuation of the debtor in possession . . . because . . . the debtor, who is familiar with his business, will be better able to operate it during the reorganization . . . . Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization."

- House Report 95-595, Judiciary Committee (1977)[19]

(discussing generally the benefits of a debtor remaining in control of the business). Shifting control to the DIP lender therefore harms the whole estate. *Id.*

17. *See infra* Part I.B.1 (explaining the historical reasons why Congress designed Chapter 11 to allow the debtor to remain in possession of the business).

18. *See infra* Part II (explaining how and why DIP lenders have come to exert a high degree of control over debtors' businesses).

19. H.R. REP. NO. 95-595, at 233.

To put this Article and its proposed solution in proper context, I begin with (a) a general overview of corporate bankruptcy and then turn to (b) the fundamental theory that the debtor remains in control of the business.

A. General Overview of Corporate Bankruptcy

Consider a business. Imagine that the business, like most businesses, has debt.[20] The business needs money to fund its operations and growth.[21] So it issues debt. The business might incur debt (voluntarily) by receiving a loan from a bank or raising capital from bondholders.[22] Despite the negative connotation among consumers, voluntarily incurring debt is often a valuable strategy for businesses.[23] The business also, though, might incur debt (involuntarily) from lawsuits.[24] As a result of a lawsuit, the business may owe money to the other party.[25]

Regardless of whether the debt is voluntary or involuntary, the debt must be repaid.[26] Sometimes, this debt becomes excessive and the business cannot afford to repay it.[27] The business may be losing money because of a macroeconomic crisis.[28] Or the business may be losing money because its

---

20. *See* Thomas R. Piper & Wolf A. Weinhold, *How Much Debt Is Right for Your Company?*, HARV. BUS. REV. (July 1982), https://hbr.org/1982/07/how-much-debt-is-right-for-your-company/ (explaining the advantages and disadvantages of corporate debt).

21. *See id.* (explaining that companies must have enough money to ensure that "no strategically important program or policy ever fails for lack of corporate purchasing power").

22. *Debt Financing*, INVESTOPEDIA, https://www.investopedia.com/terms/d/debtfinancing.asp (last visited Dec. 4, 2018).

23. *See* Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 132 (2005) ("Credit is an integral part of the economic security and well-being of our society."); *see* Piper & Weinhold, *supra* note 20 ("Empirical studies have, in general, shown that—because of the tax deductibility of interest—debt financing leads on average to an addition to company value equal to some 10 to 17% of the addition to debt.").

24. *See, e.g.*, Lukas I. Alpert, *Gawker Files for Bankruptcy, Will Be Put Up for Auction*, WALL STREET J. (June 10, 2016), https://www.wsj.com/articles/gawker-declaring-bankruptcy-will-be-put-up-for-auction-1465578030 (reporting that Hulk Hogan won a $140 million judgement against the Gawker Media Group).

25. *See, e.g.*, *id.* (reporting that Gawker Media Group went on the auction block to pay the $140 million jury judgment).

26. *Debt Financing*, *supra* note 22; *see also* Carrie Wittmer, *Everything You Need to Know About the Iron Bank of Braavos, Which Will Be Important on 'Game of Thrones' Next Sunday*, BUS. INSIDER (Aug. 1, 2017), https://www.businessinsider.com/game-of-thrones-everything-to-know-about-the-iron-bank-of-braavos-2017-8 ("The Iron Bank will have its due.").

27. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 1 ("Businesses fail. Sometimes they collapse in a loud crash. Sometimes they drift downward, like a balloon with a slow leak.").

28. *See, e.g.*, *Economy Lost More than 200,000 Small Businesses in Recession, Census Shows*, FOX NEWS (July 26, 2012), http://www.foxnews.com/politics/2012/07/26/economy-lost-more-than-200000-small-businesses-in-recession-census-shows.html (pointing to the more than 200,000 small businesses that closed during the Great Recession); Christopher J. Goodman & Steven M. Mance,

industry has been disrupted and is no longer viable.[29] Or the business may be facing a large debt from a litigation judgment.[30] For whatever reason, the business cannot satisfy its debt obligations.

As a result, the business may choose to file for bankruptcy protection under Chapter 7 or Chapter 11. Under Chapter 7, the business ceases operations and its assets are liquidated by a trustee.[31] The trustee then distributes the proceeds among the creditors.[32] Under Chapter 11, the business typically continues operations and either sells all its assets as a going concern[33] or negotiates with its creditors on a reorganization plan.[34] The plan becomes a contract[35] that details how the business will pay its creditors and shareholders.[36]

Critics question whether Chapter 11 reorganizations are worthwhile.[37] Should we give failed companies a chance to reorganize, instead of requiring them to liquidate immediately? The answer is yes, for both moral and economic reasons. From a morally abstract lens, Chapter 11 is "perhaps a predictable creation from a people whose majority religion embraces the idea of life from death and whose central myth is the pioneer making a fresh start on the boundless prairie."[38] Economically, empirical studies

---

Employment Loss and the 2007-2009 Recession: An Overview, MONTHLY LAB. REV., Apr. 2011, at 3, https://www.bls.gov/mlr/2011/04/art1full.pdf ("Virtually no area of the economy remained unscathed from the December 2007–June 2009 recession . . . .").

29. One particular example is the retail industry, which has been disrupted by online commerce. *See, e.g.*, Kim Bhasin, *Retailers Are Going Bankrupt at a Record Pace*, BLOOMBERG L. (Apr. 24, 2017), https://www.bloomberg.com/news/articles/2017-04-24/retailers-are-going-bankrupt-at-a-record-pace ("Retailers are filing for bankruptcy at a record rate as they try to cope with the rapid acceleration of online shopping.").

30. *See, e.g.*, Alpert, *supra* note 24 (explaining that Gawker filed for bankruptcy after a court upheld the $140 million judgment entered against the company).

31. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978 (2017).

32. *Id.* ("In Chapter 7, a trustee liquidates the debtor's assets and distributes them to creditors." (citing 11 U.S.C. § 701 (2012))).

33. *See, e.g.*, Christie Smythe, *GM, Chrysler Highlight Growing 363 Sale Trend*, LAW360 (July 10, 2009), https://www.law360.com/articles/110638/gm-chrysler-highlight-growing-363-sale-trend (noting that a § 363 sale that keeps the company operating as a going concern is an alternative to Chapter 11 reorganizations).

34. *Czyzewski*, 137 S. Ct. at 978 ("In Chapter 11, debtor and creditors try to negotiate a plan that will govern the distribution of valuable assets from the debtor's estate and often keep the business operating as a going concern." (citing 11 U.S.C. §§ 1121, 1123, 1129, 1141 (2012))).

35. *See, e.g.*, *In re* MPF Holdings US LLC, 701 F.3d 449, 457 (5th Cir. 2012) ("[C]ourts regularly apply principles of contract interpretation to clarify the meaning of the language in reorganization plans."); Hillis Motors, Inc., v. Haw. Auto. Dealers' Ass'n, 997 F.2d 581, 588 (9th Cir. 1993) ("A reorganization plan resembles a consent decree and therefore, should be construed basically as a contract.").

36. *See* 11 U.S.C. § 1123(a)(1)–(5) (outlining required elements of a reorganization plan).

37. Elizabeth Warren & Jay L. Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 604 (2009).

38. *Id.* at 604.

confirm that Chapter 11 reorganizations are feasible[39] and generate more value than Chapter 7 liquidations.[40]

To illustrate, consider a restaurant.[41] In a Chapter 7 liquidation, the company's assets would be sold in a piecemeal fashion.[42] The ovens may be sold to one bidder, the tables to another, and the forks and spoons possibly to another.[43] Sold separately, these assets would generate less value than if the company could reorganize and operate (or sell itself) as a functioning restaurant.[44] The assets, when together, form a synergy that generates extra value; the whole becomes greater than the sum of its parts.[45] A Chapter 11 reorganization thus typically generates more value for creditors than it otherwise would as a Chapter 7 liquidation.[46]

As Justice Breyer recently explained, filing for Chapter 11 results in three legal consequences.[47] One, an estate is created.[48] Two, an automatic stay is implemented.[49] And three, with special relevance to this Article, "a fiduciary is installed to manage the estate."[50]

---

39. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 18 (noting that debtors get a plan confirmed over 70% of the time when the debtor "still has some resources and makes a serious effort at reorganization" (citing Warren & Westbrook, *supra* note 37, at 603)).

40. Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 24 (2007) ("[R]eorganized companies recover about 75% of their book value, compared to a 29% recovery ratio for those that sell."); Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation Versus Chapter 11 Reorganization*, 61 J. FIN. 1252, 1269 (2006) ("[T]he average Chapter 11 case retains value 78% better than the average Chapter 7 case.").

41. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 11 ("A piecemeal liquidation of a business—a sale on the courthouse steps of the salad spoons, mixing bowls, tables and chairs, double-door refrigerators, and leasehold of a restaurant—is likely to yield much less money than the sale of these items together as a restaurant.").

42. Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 978 (2017).

43. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 11 (using a similar analogy).

44. *Id.*

45. *See* ARISTOTLE, *Metaphysics*, *in* THE WORKS OF ARISTOTLE, VOL. I, 1045a (Robert Maynard Hutchins ed., W.D. Ross trans., 1952) (c. 350 B.C.E.) ("[T]he totality is not, as it were, a mere heap, but the whole is something besides the parts.").

46. Bris, Welch & Zhu, *supra* note 40.

47. *Czyzewski*, 137 S. Ct. at 978–79.

48. *See* 11 U.S.C. § 541(a) (2012) ("The commencement of a case . . . creates an estate."); *see also* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 27 ("[B]oth the benefits and the burdens of Chapter 11 will belong to the new estate, which will bear the responsibility of maximizing value for the creditors collectively.").

49. 11 U.S.C. § 362(a); *see generally* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 27 (discussing the imposition of an automatic stay).

50. *Czyzewski*, 137 S. Ct. at 978.

B. Chapter 11 Fiduciary: The Debtor in Possession

After a debtor files for Chapter 11 relief, a fiduciary is installed to manage the bankruptcy estate.[51] But who becomes the fiduciary? Should the debtor's management continue in its managerial role? Or should the court automatically appoint an independent trustee, like in Chapter 7? The simple answer is the former—the debtor's management may continue operating the business.[52] Such a debtor—one that continues in control—is called a "debtor in possession" because the debtor remains *in possession* of the business.[53] A proper understanding of this concept, however, requires further discussion of its legislative history and rationale.

1. Legislative History

The U.S. Constitution grants Congress the power to legislate "uniform Laws on the subject of Bankruptcies throughout the United States."[54] Throughout the 18th and 19th centuries, states differed in their approach to federal bankruptcy law.[55] As a result, Congress struggled to pass a bankruptcy law with any stability; Congress would pass bankruptcy laws during economic downturns and then repeal those laws just a few years later once the economy strengthened.[56] Congress's efforts were akin to

---

51. *See* 11 U.S.C. § 1106 (describing the duties of a trustee).

52. *Id.* §§ 1107–08.

53. *Id.* § 1101(1) (defining a "debtor in possession" as the "debtor except when a person that has qualified under section 322 of this title is serving as trustee in the case").

54. U.S. CONST. art I, § 8, cl. 4. James Madison expressed the importance of a federal bankruptcy law in The Federalist No. 42, writing:

> The power of establishing uniform laws of bankruptcy, is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question.

THE FEDERALIST NO. 42, at 287 (James Madison).

55. *See* Miller & Waisman, *supra* note 23 ("Congress rarely reached consensus throughout the late eighteenth and nineteenth centuries as to bankruptcy legislation."); DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 23 (2001) [hereinafter SKEEL, DEBT'S DOMINION] ("[B]ankruptcy became one of the great legislative battlegrounds of the nineteenth century.").

56. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 6; *see* Miller & Waisman, *supra* note 23, at 133 (discussing the relationship between bankruptcy law and the economy); SKEEL, DEBT'S DOMINION, *supra* note 55 ("Prior to 1898, Congress passed a series of bankruptcy laws, each of which quickly unraveled and led inexorably to repeal.").

fixing a broken roof with tape to prevent leaks, and then removing the tape when the rain stopped.

Eventually, Congress replaced this unstable patchwork with the Bankruptcy Act of 1898 (1898 Act); Congress bought a new roof.[57] The 1898 Act provided the foundation for a stable federal bankruptcy system and set the tone of American bankruptcy law—one much different from the law across the pond.[58] In Britain, bankruptcy was a creditor-favored system that the government ran with large administrative interference.[59] In contrast, the 1898 Act established that the American bankruptcy system would be a debtor-friendly system driven by the parties in interest and their lawyers.[60] Further, the 1898 Act was more forgiving to debtors than the laws in Britain.[61] Though the 1898 Act did not codify the power of a debtor in possession, it established an overarching, parallel theme—American bankruptcy law was to be (and remains) debtor-friendly with minimal governmental interference.[62]

The 1898 Act was a building block for future legislation.[63] Inspired by the Great Depression in the 1930s, Congress realized it needed a more robust statutory framework to handle the increase in bankruptcies that come during an economic crisis.[64] For guidance, Congress looked to the railroad industry.[65] Remarkably, and organically, the railroad industry had created its own successful bankruptcy system by using receiverships to handle insolvencies.[66] The receivership process contained many recognizable, modern-day features of bankruptcy: a petition,[67] a stay of litigation,[68]

---

57. *See* David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 EMORY BANKR. DEVS. J. 321, 321–22 (1999) [hereinafter Skeel, *Genius*] (describing the 1898 Act as enduring and its predecessors as lackluster and short-lived).

58. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 6; *See* SKEEL, DEBT'S DOMINION, *supra* note 55 ("With the Bankruptcy Act of 1898, the instability suddenly came to an end . . . . [F]ederal bankruptcy has been a permanent fixture ever since.").

59. *See* Skeel, *Genius*, *supra* note 57, at 328 (describing the character of the British bankruptcy system).

60. *Id.*

61. *Id.*

62. *Id.* at 325–26.

63. *See* Miller & Waisman, *supra* note 23, at 133 (describing how the Chandler Act amended the Bankruptcy Act of 1898).

64. *Id.* at 133–34.

65. *Id.* at 134; Skeel, *Debtor-In-Possession*, *supra* note 10, at 1908 (explaining how "the railroad receivership process . . . eventually led to Chapter 11").

66. *See* Skeel, *Debtor-In-Possession*, *supra* note 10, at 1908–13 (describing the historical development of the equitable receivership system).

67. *See* Miller & Waisman, *supra* note 23, at 135 ("The process generally began with the filing of a 'creditor's bill' . . . ."); Skeel, *Debtor-In-Possession*, *supra* note 10, at 1908 ("[A] creditor would first file a 'creditor's bill' asking the court to appoint a receiver to oversee the defaulting railroad's property.").

creditor committees,[69] a reorganization plan,[70] and most notably, the retention of the debtor's management.[71]

Adopting many of these features, Congress passed the Bankruptcy Act of 1938 (1938 Act) and created two separate chapters for business reorganizations: Chapter X for large public companies and Chapter XI for small private companies.[72]

Chapter X provided a statutory framework for how distressed companies should reorganize.[73] Most notably, Chapter X did not permit debtors to remain in possession.[74] Although the railroad industry favored debtors in possession, critics worried that debtors in possession gave Wall Street too much power and would overly compensate attorneys and other professionals to the detriment of creditors.[75] The newly-formed Securities and Exchange Commission (SEC) commissioned a study on the issue and eventually proposed that during Chapter X bankruptcy, a judge would replace the debtor's management.[76] Congress agreed with the SEC; the management and professionals of the bankruptcy estate should be disinterested.[77] Thus, if a debtor filed for Chapter X, a trustee would

---

68. *See* Miller & Waisman, *supra* note 23, at 135 ("The filing of a creditor's bill acted as a modern-day 'automatic stay.'"); Skeel, *Debtor-In-Possession*, *supra* note 10, at 1908 ("If a creditor tried to obtain a lien against railroad property, for instance, the receiver would simply ask the court for an injunction.").

69. *See* Miller & Waisman, *supra* note 23, at 135 ("Multiple protective committees of bondholders and stockholders would be formed to represent respective stakeholders in the bargaining process . . . ."); Skeel, *Debtor-In-Possession*, *supra* note 10, at 1909 (describing the use of reorganization committees).

70. *See* Miller & Waisman, *supra* note 23, at 135 ("The negotiations would culminate in a reorganization plan that would recapitalize the railroad as a new entity and distribute new securities to the stockholders pursuant to the plan."); Skeel, *Debtor-In-Possession*, *supra* note 10, at 1909 ("Once they had agreed to an overall plan, the committees were combined to form a single super-committee called the 'Reorganization Committee.'").

71. *See* Miller & Waisman, *supra* note 23, at 135–36 (noting that one of the "central modern bankruptcy concepts [that] emerged from the railroad receivership paradigm" was "the retention and active participation of the railroad's management in the operations of the railroad and the development of a business plan to support a reorganization"); *id.* at 136 (discussing the 1884 bankruptcy of Wabash, St. Louis, and Pacific Railway as an example of the debtor-in-possession concept).

72. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 7; Miller & Waisman, *supra* note 23, at 137–38.

73. Miller & Waisman, *supra* note 23, at 138.

74. *See id.* at 139 ("Management and, in effect, the board of directors were displaced by the mandatory appointment of a reorganization trustee, and there was a significant loss of control by traditional power groups.").

75. *Id.* at 137–39.

76. *Id.*

77. *Id.* at 139.

automatically replace the management.[78] Further, Congress granted the SEC the authority to monitor and investigate reorganizations.[79]

Chapter XI, though, was different. Congress felt that the complex statutory framework of Chapter X and the constant oversight of the SEC were too burdensome for small businesses.[80] So Congress created Chapter XI and allowed small debtors to remain in possession; a trustee was not automatically appointed in these proceedings.[81]

Chapter XI thus was much more attractive to a distressed business than Chapter X. Chapter XI allowed the debtor's management to stay in control, free from SEC oversight, whereas Chapter X required a trustee to replace the management and the SEC to monitor the reorganization.[82]

Frustrated by the administrative interference and related delays within Chapter X, debtors routinely tried to find ways to fit into the Chapter XI paradigm.[83] A pattern emerged. A large debtor, of the size required for Chapter X, would file instead for Chapter XI.[84] The SEC would then try to convert the bankruptcy case to Chapter X.[85] The debtor and the SEC would then negotiate and often agree to the following settlement: the SEC would leave the case in Chapter XI, as long as the debtor treated bondholders and stockholders to the SEC's satisfaction.[86] And with that, the large debtor achieved its goal—a Chapter XI proceeding that allowed its management to stay in control.

After forty years of debtors circumventing Chapter X, Congress overhauled the bankruptcy system by enacting the Bankruptcy Reform Act of 1978 (1978 Reform Act and the current Bankruptcy Code).[87] Among many other things, the 1978 Reform Act established one chapter for business reorganizations—Chapter 11—that combined the features of the former Chapters X and XI.[88] The new Chapter 11 contained the structural framework of Chapter X and the debtor in possession concept of Chapter XI.[89]

---

78. *Id.*

79. *Id.*

80. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 7.

81. Miller & Waisman, *supra* note 23, at 140.

82. *Id.*

83. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 8; Miller & Waisman, *supra* note 23, at 141.

84. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 8.

85. *Id.*

86. *Id.*

87. Miller & Waisman, *supra* note 23, at 141–42.

88. *Id.* at 142 ("The new Chapter 11 combined the flexibility and debtor control that characterized Chapter XI with many of the public protection features central to Chapter X.").

89. *Id.*

Chapter 11 of the Bankruptcy Code thus explicitly permits a debtor's management to remain in control.[90] Section 1107 gives a debtor in possession all the rights and powers of a trustee.[91] Section 1108 gives a trustee the power to operate the debtor's business.[92] Read together, the two sections form one of the fundamental theories of Chapter 11: the power of a debtor to operate its own business throughout the reorganization.[93] Provided a court does not appoint a trustee under § 1104—for, among other things, fraud or gross mismanagement—a Chapter 11 debtor will remain in possession of its business.[94]

2. Rationale

Why, though, should the debtor remain in control? Because the debtor, as opposed to a trustee, is more familiar with its business and is thus better able to manage its operations.[95] The debtor would not require time or money to learn about the business because the debtor is already familiar with it.[96] A trustee, on the other hand, would require valuable time and money from the estate to educate itself.[97] Such time and money must be preserved whenever possible and used efficiently to maximize the value of the estate.[98]

---

90. *See* S. REP. NO. 95-989, at 116 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5902 ("This section places a debtor in possession in the shoes of a trustee in every way.").

91. 11 U.S.C. § 1107 (2012).

92. *Id.* § 1108.

93. *See id.* § 1107(a) ("[A] debtor in possession shall have all the rights, other than the right to compensation . . ., of a trustee serving in a case under this chapter."); *id.* § 1108 ("[T]he trustee may operate the debtor's business.").

94. *Id.* §§ 1104 (a)(1), 1115(b).

95. As the House judiciary committee noted:

> In fact, very often the creditors will be benefited by continuation of the debtor in possession . . . the debtor, who is familiar with his business, will be better able to operate it during the reorganization . . . . Thus, a debtor continued in possession may lead to a greater likelihood of success in the reorganization.

H.R. REP. NO. 95-595, at 233.

96. *Id.*

97. *See id.* ("A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way."); *see also* David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 517 n.188 (1993) ("In the nonclosely held firm context, immediate removal of management would create significant indirect costs both before and during bankruptcy.").

98. Debtors in bankruptcy are often referred to as "melting ice cube[s]." Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE

Further, allowing the debtor to stay in control encourages the debtor's management to file for bankruptcy because it reassures management that they will not lose their jobs.[99] If a trustee automatically replaced management, then management would be hesitant to file for bankruptcy.[100] This would encourage management to delay filing as long as possible and cause the debtor to lose more value, making a reorganization improbable.[101]

Critics, on the other hand, argue that this theory of control is misguided, and that the bankrupt debtor should not remain in control of the business.[102] These criticisms come in two flavors: incompetence and exploitation.

First, incompetence.[103] Some critics wonder why a failed management should continue to operate a failed business? If the management led the company into bankruptcy, how can we expect the management to lead the company out of bankruptcy? One answer is that the management responsible for the failure has already likely been ousted and replaced with management responsible for turning the company around.[104] An increasing

---

L.J. 862, 865 (2014). The theory is that the debtor is losing value each day of the bankruptcy proceeding. *Id.* ("Financially distressed companies can melt like ice cubes: every day that a company burns through more cash than it earns, it loses value."). All parties to the proceeding thus want the proceeding to conclude as fast as possible so that value is preserved. *See* LoPucki & Doherty, *supra* note 6, at 30–31 (noting that Polaroid used the melting ice cube argument during a bankruptcy proceeding); *see also, e.g.*, *In re* Chrysler LLC, 576 F.3d 108, 119 (2d Cir. 2009) ("With its revenues sinking, its factories dark, and its massive debts growing, Chrysler fit the paradigm of the melting ice cube."), *vacated*, Ind. State Police Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009).

99. *See* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 63 ("If managers know it is virtually certain that they will be replaced in Chapter 11 even if they are doing a good job in trying to turn around a troubled business, they will be disinclined to file even if it would be the wisest course for the business.").

100. *Id.*

101. *See* Miller & Waisman, *supra* note 23, at 140 ("Management, fearful of being displaced, would delay the commencement of bankruptcy cases. Often, during this process, the deterioration of the debtor's business would continue unabated and sometimes result in the loss of the ability to reorganize and rehabilitate." (footnote omitted)).

102. FINAL REPORT, *supra* note 6, at 22–23 (discussing criticisms of the debtor-in-possession model).

103. *See id.* at 22 ("Some critics argue that allowing the management team that was in charge during the debtor's financial decline to remain in control rewards subpar performance and undermines confidence in the reorganization process for the debtor's stakeholders."); *see* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 60 ("Old management, after all, often comprises the same folks who brought the business to the brink of collapse, which may not be a strong endorsement for their management skills and business acumen.").

104. A 2009 study showed that 70% of CEOs were replaced within the two years prior to their companies' bankruptcy petitions. Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 521–22 (2009). Earlier studies from 2006 and 1989 showed that about 50% of CEOs were replaced during similar periods. *See* Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed? Increasingly Performance Sensitive Boards and Increasingly Uneasy CEOs* 25 (Nat'l Bureau of Econ. Research, Working Paper No. 12465, 2006),

trend is for the company to hire a Chief Restructuring Officer (CRO): an outsider who assists the company in its reorganizing and becomes responsible for many of the company's major decisions.[105] Further, the debtor's management may not be responsible for the financial distress.[106] External factors, such as natural disasters, could cause such distress.[107]

Second, exploitation.[108] Other critics argue that this fundamental theory increases the potential that the debtor will exploit the bankruptcy estate.[109] How can we trust the debtor to act in the estate's best interest, as opposed to its own best interests? There are a variety of protections against this concern. For one, the court must approve substantial decisions.[110] Parties in interest, such as creditors, can object and voice their displeasures before the

---

http://www.nber.org/papers/w12465 (indicating that as many as 45% of Fortune 500 companies replaced their CEOs in the 1999–2000 period); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECONS. 241, 251 (1989) (reporting 55% CEO turnover). If you consider the months immediately after a bankruptcy petition, the turnover rate is even higher. Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723, 729 (1993) (finding 95% top management turnover in the 18 months preceding and the 6 months following the bankruptcy petition).

105. *See generally* Shai Y. Waisman & John W. Lucas, *The Role and Retention of the Chief Restructuring Officer*, *in* THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009, at 200–05 (2008), https://1pdf.net/the-role-and-retention-of-the-chief-restructuring-officer-d_590b15e7f6065d3f3ef14618 (providing an overview of the CRO's functions). For example, SunEdison, a renewable energy developer that filed for bankruptcy in April 2016 with $20.7 billion of assets, hired John Dubel as the company's CRO. Brian Feldt, *SunEdison Brings in Turnaround Expert for Restructuring*, ST. LOUIS BUS. J. (May 2, 2016), http://www.bizjournals.com/stlouis/blog/biznext/2016/05/sunedison-brings-in-turnaround-expert-for.html; *SunEdison Files for Bankruptcy Protection*, CNBC (Apr. 21, 2016), https://www.cnbc.com/2016/04/21/sunedison-files-for-bankruptcy-protection-report.html. Dubel was, among other things, "in charge of the management of all aspects of the financial restructuring of the company." Feldt, *supra*. These aspects included the responsibility of "directing the efforts of the company's management, employees and external professionals in bankruptcy-related matters and transactions, directing the development of a Chapter 11 plan, and managing the obligations owed by the company to its significant creditors." *Id.*

106. *See* Gregory Hamel, *What are the Causes of Business Bankruptcy?*, CHRON, https://smallbusiness.chron.com/causes-business-bankruptcy-49407.html (last visited Dec. 4, 2018) ("Unforeseen disasters and criminal activity like floods, storms, fires, theft and fraud can also cause hardships that lead to bankruptcy.").

107. *Id.*

108. FINAL REPORT, *supra* note 6, at 22–23 ("Some critics also worry that prepetition management may be motivated by factors not necessarily aligned with the best interests of the estate, such as retaining their jobs or downplaying prepetition events that may implicate them in the debtor's financial distress."); *see* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 60–62 (discussing various incentives prepetition management might have to act against the estate's interests).

109. *See, e.g.*, WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 61 ("[O]ld management's primary loyalty may be to the new investors who fund the reorganization, even if that loyalty is not conducive to increasing the value of the estate for distribution to the old creditors.").

110. *See id.* at 65 ("The DIP, for example, can operate the business *only* in the ordinary course without court approval, and it must negotiate either a consensual plan or a plan that pays all creditors in full before old equity holders retain any ownership.").

court.[111] Further, the court may replace the debtor in possession with a Chapter 11 trustee if cause exists (i.e., fraud) or if it is necessary for the well-being of the estate.[112] The Bankruptcy Code thus provides checks and balances against a manipulative debtor in possession.[113]

Foreign legislatures, recognizing the benefits of a debtor staying in possession, have started to adopt similar policies. In 2012, Germany changed its insolvency law to closely mirror the U.S. law.[114] Prior to the new law, a German debtor was allowed to maintain possession of the business only in extremely rare circumstances; possession was not a presumption.[115] The new German law, however, keeps the debtor in control and free from administrative interference (such as a trustee).[116]

In 2016, the European Union proposed a directive to its member states for reforming their restructuring/insolvency laws.[117] The directive, still being considered, has proposed that debtors shall remain in possession, unless a party moves otherwise.[118] The directive explained that automatically appointing a trustee results in higher costs.[119] By emulating the American model, these international efforts provide support for its merit.

Nonetheless, the purpose of this Article is not to argue whether the policy is a sound one, though the American Bankruptcy Institute (ABI) believes it is.[120] In 2014, an ABI-commissioned study concluded that the U.S. should retain the current debtor in possession concept.[121] Continued debtor control of its business during a Chapter 11 proceeding is a well-established element of the bankruptcy system that the Bankruptcy Code

---

111. *Id.* at 69.

112. 11 U.S.C. § 1104(a)(1)–(2) (2012); *see also* WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 55–56 (outlining the situations in which a trustee would be appointed).

113. WARREN, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 65 ("The [debtor in possession] is in control of the day-to-day operations, but the Code is replete with specific checks to ensure that creditor interests are appropriately protected.").

114. Leo Plank, Bernd Meyer-Löwy, Jonathan S. Henes & Carl Pickerill, *Germany's Revised Bankruptcy Code*, DEAL PIPELINE (Jan. 12, 2012), https://www.kirkland.com/siteFiles/Publications/DealPipeline_Plank.pdf.

115. *Id.*

116. *Id.*

117. European Comm'n, *Proposal for a Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU*, at 4–5 (Nov. 22, 2016), http://ec.europa.eu/transparency/regdoc/rep/10102/2016/EN/SWD-2016-357-F1-EN-MAIN-PART-1.PDF.

118. *Id.* at 64–66.

119. *Id.* at 64.

120. FINAL REPORT, *supra* note 6, at 24 ("Accordingly, the Commission recommended retention of the debtor in possession model.").

121. *Id.*

explicitly provides for.[122] This fundamental theory of control, however, has eroded in practice.

II. IN PRACTICE: THE DIP LENDER HAS CONTROL

"Given their economic leverage, the pre-chapter 11 lenders or their successors have used the granting of DIP financing as the means to exert substantial control over the debtor and chapter 11 case. . . . Effectively, the debtor in possession is neutered."

– Harvey Miller, Bankruptcy Expert (2007)[123]

In name, the debtor remains "in possession" of the business.[124] In form, though, the debtor often forfeits significant control rights to the DIP lender.[125] Part II looks closer at this phenomenon. Specifically, this Part

---

122. *See* 11 U.S.C. § 1107(a) (2012) (granting the debtor in possession all the rights and duties of a trustee except the right to compensation); FINAL REPORT, *supra* note 6, at 21 (calling the debtor-in-possession concept a "fundamental feature" of the Chapter 11 bankruptcy code).

123. Harvey R. Miller, Keynote Address at the International Institute of Insolvency (June 2007), http://www.lexology.com/library/detail.aspx?g=21fea83c-b0df-4f12-9672-d437da81fd44.

124. 11 U.S.C. § 1101(1).

125. Melissa Jacoby, *Corporate Bankruptcy Hybridity*, 166 U. PA. L. REV. 1715, 1730–31 (2018) (explaining that DIP financing terms have become "'odious' even [to] restructuring professionals" and that "a perhaps bigger concern is how prepetition lenders use DIP lending to direct the activities of the bankruptcy estate"); Kirshner, *supra* note 15, at 537 ("DIP lenders have leveraged their position to gain control of the bankruptcy process and maximize their individual recoveries."); KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 ("[O]verall bargaining power still weighs generally in favor of DIP lenders. This has . . . result[ed] in more DIP lender control over the debtor and the Chapter 11 process."); Paul Leake, *The Examiners: Make DIP Financing More Restructuring-Friendly*, WALL STREET J. (Dec. 3, 2014), https://blogs.wsj.com/bankruptcy/2014/12/03/the-examiners-make-dip-financing-more-restructuring-friendly/ (arguing that DIP financing needs to be "more readily available on terms that support a more predictable and orderly Chapter 11 process that maximizes the value of the enterprise"); FINAL REPORT, *supra* note 6, at 77 n.301 ("Regardless of where the debtor gets its DIP financing, the game has dramatically changed . . . . [Lenders often] take control of the debtor, through covenants, deadlines, and default provisions. And these are no mere financial tests to ensure the safety of the lender's repayment." (quoting Kathryn Coleman, Has the 'Fresh Start' Gone Stale: Written Statement to the Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, at 4–5 (Nov. 3, 2012))); *see* Douglas B. Rosner, Venue Fairness: Written Statement on Behalf of Nat'l Ad Hoc Grp. of Bankr. Practitioners in Support of Venue Fairness to the Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, at 15 (Nov. 22, 2013), http://commission.abi.org/sites/default/files/statements/22nov2013/Written-Venue%20Statement-for-ABI-Commission.pdf ("Bankruptcy courts felt compelled to approve more expensive debtor in possession financing and enter orders containing extraordinary terms (e.g., roll ups, quick sales, excessive fees and interest rates, liens on avoidance recoveries, etc.)."); *Q&A With Perkins Coie's David Neff*, LAW360 (Apr. 30, 2013) [hereinafter *Neff*], http://www.law360.com/articles/424470/q-a-with-perkins-coie-s-david-neff ("[T]he balance of power [has] shift[ed] substantially away from debtors . . . . [T]he changes . . . have greatly restricted debtors' abilities to reorganize."); Paul H. Zumbro, *An Overview of Debtor-in-Possession Financing*, *in* INSIDE THE MINDS: DEBTORS-IN-POSSESSION AND EXIT FINANCING 10 (Thomson

explains: (a) § 364 of the Bankruptcy Code, which authorizes and governs DIP financing; (b) the DIP loan provisions that lenders often implement to exert control over the debtors in possession; and (c) the impact of the 2008 Great Recession.

A. Section 364: Obtaining Credit

DIP financing provides the debtor in possession with the cash necessary to operate throughout the restructuring.[126] Without it, the debtor in possession would not be able to pay employees or critical vendors and therefore would be forced to cease operations and liquidate.[127] DIP financing thus is often required for a successful Chapter 11 reorganization.[128] Empirical studies confirm that companies with DIP financing are more likely to emerge successfully from bankruptcy.[129]

Reuters/Aspatore 2010) ("DIP lenders have the ability to exert a degree of control over the debtor company and the Chapter 11 process, principally by imposing covenants on the debtor under the DIP credit agreement."); Ayotte & Morrison, *supra* note 104, at 538 ("Creditors dictate the dynamics of the reorganization process. Senior lenders exercise significant control through stringent covenants contained in DIP loans."); Miller, *supra* note 123 ("Given their economic leverage, the pre-chapter 11 lenders . . . have used the granting of DIP financing as the means to exert substantial control over the debtor and chapter 11 case. Negotiations over DIP agreements tend to be one-sided, with lenders structuring such agreements to enhance . . . control."); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1239 (2006) [hereinafter Baird & Rasmussen, *Private Debt and the Missing Lever*] ("The typical debtor-in-possession (DIP) loan grants the lender virtually complete control over the reorganization process."); Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425, 456–57 (2006) (book review) ("DIP financing is now the most important corporate governance lever in Chapter 11."); Miller & Waisman, *supra* note 23, at 154 ("Such leverage has enabled DIP lenders to impose increasingly severe covenants and conditions on the debtor and its activities to the point that control of the Chapter 11 case has been taken away from the bankruptcy court."); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 925 (2003) ("Lenders have responded to the greater importance of post-petition financing and to creditors' concerns about the Chapter 11 process by using the terms of DIP loans to shape the Chapter 11 case.").

126. *See generally* HENRY P. BAER JR. ET AL., DEBTOR-IN-POSSESSION FINANCING: FUNDING A CHAPTER 11 CASE 1 (Felicia Gerber Perlman ed., Am. Bankr. Inst. 2012) (explaining that businesses filing for Chapter 11 need access to credit to fund operations and restructuring); Skeel, *Debtor-In-Possession*, *supra* note 10, at 1917 (discussing how a DIP loan provides a debtor in possession with the necessary cash flow).

127. Zumbro, *supra* note 125, at 8 ("DIP financing provides the debtor with liquidity to fund its ongoing working capital needs and serves as an important signal to the marketplace that the debtor will have the ability to fund its ongoing operations during the pendency of its Chapter 11 case.").

128. *See In re* Ames Dep't Stores, Inc., 115 B.R. 34, 36 (Bankr. S.D.N.Y. 1990) ("It is given that most successful reorganizations require the debtor-in-possession to obtain new financing simultaneously with or soon after the commencement of the Chapter 11 case."); Bruce A. Henoch, *Postpetition Financing: Is There Life After Debt?*, 8 EMORY BANKR. DEVS. J. 575, 575–76 (1991) ("Without financing to keep the debtor-in-possession . . . in business, the company will . . . fail quickly."); Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 S. CAL.

Section 364 of the Bankruptcy Code authorizes and governs postpetition credit, such as DIP financing.[130] Specifically, § 364 permits three types of priority[131] for postpetition credit. From weakest to strongest, the types of priority are: (i) administrative with no lien;[132] (ii) super-priority administrative with a non-priming lien;[133] and (iii) super-priority administrative with a priming lien.[134] All priorities, unless the debt is incurred in the ordinary course of business, are subject to court approval.[135] I discuss them in turn.

L. REV. 109, 111 (1986) ("Without [DIP] financing a successful reorganization probably would not be possible.").

129. As Federick Tung reports:

> My data are consistent with findings in the finance literature that the presence of a DIP loan is associated with a higher likelihood of emerging from Chapter 11. Sixty-four percent of all cases in the sample emerged from bankruptcy. Of emerging cases, 77% of debtors with DIP loans emerged, while only 43% of debtors without DIP financing emerged.

Frederick Tung, *Do Economic Conditions Drive DIP Lending?: Evidence from the Financial Crisis* 17 n.42 (Bos. Univ. Sch. of Law, Law and Economics Research Paper No. 16-38), https://ssrn.com/abstract=2828295; Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Survival*, 62 UCLA L. REV. 970, 1001 (2015) [hereinafter *Bankruptcy Survival*] ("Two earlier studies have shown that companies that obtain DIP loans are more likely to survive than companies that do not. Our findings are consistent with theirs."); FINAL REPORT, *supra* note 6, at 76 (referring to a study by the Loan Syndications and Trading Association that found a 69% reorganization rate among firms with DIP financing compared to a 52% rate among firms without such financing); Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. FIN. ECON. 259, 271 (2003) ("[F]irms that obtain DIP financing are more likely to emerge successfully.").

130. *See* 11 U.S.C. § 364(b) (2012) (authorizing a "trustee to obtain unsecured credit" after notice and hearing).

131. A creditor's type of priority is often the difference between being paid in full or being paid cents on the dollar. *See* Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 786 (2017) ("If one creditor has priority over another, this creditor needs to be paid in full before the other is entitled to receive anything."). The estate must pay high priorities—such as administrative expenses paid to the bankruptcy professionals, lawyers, accountants, etc.—in full before low priorities—such as general, unsecured creditors. *See* Richard M. Hynes & Steven D. Walt, *Inequality and Equity in Bankruptcy Reorganization*, 66 U. KAN. L. REV. 875, 877 (2018) ("The Code grants priority to administrative expenses over general unsecured claims."). Further, the estate must pay these unsecured creditors in full before equity holders receive anything. *Id.*

132. 11 U.S.C. § 364(a)–(b); COLLIER ON BANKRUPTCY ¶ 364.01 (Richard Levin & Henry J. Sommer eds., 16th ed. 2018) [hereinafter COLLIER].

133. 11 U.S.C. § 364(c); COLLIER, *supra* note 132.

134. 11 U.S.C. § 364(d)(1); COLLIER, *supra* note 132.

135. *See In re* Landsource Cmtys. Dev. LLC, 476 B.R. 454, 461 (Bankr. D. Del. 2012). Specifically, the bankruptcy court noted its role as a negotiator:

> [T]he bankruptcy court, . . . as final arbiter of whether the [DIP] financing should be approved, often acts as the last and perhaps most effective negotiator against the secured lender. It is a[] [somewhat] awkward position for a judge

1. Administrative With No Lien

First and foremost, the debtor in possession may obtain unsecured credit; such credit is given administrative priority.[136] If the credit is obtained outside the ordinary course of business, then the debtor in possession needs the court's approval.[137] If the credit is obtained within the ordinary course of business, then the debtor does not need court approval.[138] Employee wages[139] and taxes[140] are examples of debt obtained in the ordinary course of business and given administrative priority without any court approval.

Just like other debts, whether a DIP loan qualifies as a debt that the debtor incurs in the ordinary course of business is fact-specific and determined by the court.[141] To make such a determination, courts typically rely on two tests: a *vertical test* and a *horizontal test*.[142]

Under the *vertical test*, courts look at how the credit transaction between the debtor and creditor compares with the parties' past relationship and past transactions.[143] For a blunt example, consider a lender that loans $1,000 to the debtor on the first day of every month for business purposes.

> who is supposed to resolve disputes and not become involved in the administration of the business of the estate, but it perhaps has become essential given the nature of the process.

Id. (quoting COLLIER, *supra* note 132, ¶ 364.06).

136. 11 U.S.C. § 364(a); S. REP. NO. 95-989, at 57–58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5843–44.

137. 11 U.S.C. § 364(b).

138. *Id.* § 364(a); *see* Bagus v. Clark (*In re* Buyer's Club Mkts., Inc.), 5 F.3d 455, 457–58 (10th Cir. 1993) ("[I]f a debtor had to seek court approval to pay for every expense incurred during the normal course of its affairs, the debtor would be in court more than in business.").

139. 11 U.S.C. § 503(b)(1)(A)(i).

140. *Id.* § 503(b)(1)(B).

141. *In re* Ockerlund Constr. Co., 308 B.R. 325, 328–29 (Bankr. N.D. Ill. 2004).

142. *Id.* at 328 n.1.

143. As the *Ockerlund* court explained:

> To prove that an unsecured post-petition loan was obtained in the ordinary course of the debtor's business, the debtor must pass the "vertical" dimensions test. Under this test, the Court examines the reasonable expectations of creditors in light of their past relationship with the debtor and its incurrence of debt, including the amount, terms, frequency, sources, and timing of pre-petition extensions of credit from various sources.

Id. at 328–29 (footnote omitted).

If the debtor files bankruptcy in the middle of a month, and the lender loans another $1,000 on the first day of the following month, then a court would likely find that the loan was made in the ordinary course of business because the loan was similar to previous loans.[144]

Some courts apply only the *vertical test*.[145] Other courts, however, require that the debtor satisfy a *horizontal test* in addition to the *vertical test*.[146] Under the *horizontal test*, courts look at how the credit transaction compares with the practices of the debtor's industry.[147] Refer back to the earlier example of a lender loaning $1,000 every month. To satisfy the *horizontal test*, the parties must show that other businesses in the applicable industry typically incur similar debt.[148] If no other business in the industry receives a similar loan, then a court would likely find that our example—the $1,000 monthly loan—was not incurred in the ordinary course of business.[149]

But the fact-specific issue—of whether the debt was obtained in the ordinary course of business—is essentially moot for DIP loans because DIP lenders do not typically seek priority under § 364(a).[150] Rather, they seek the greater protection that the other subsections of § 364 permit: a super-priority administrative claim with a lien—either priming or not—attached.[151]

2. Super-Priority Administrative With A Non-Priming Lien

If the debtor in possession cannot obtain unsecured credit with administrative priority, the court may provide further protection for the

144. *See id.* at 328 n.1 (explaining how courts examine prepetition debts to determine whether postpetition loans were incurred in the ordinary course of business).

145. *Id.*

146. *Id.*

147. *Id.* ("Other courts have additionally required the debtor to satisfy the 'horizontal dimensions test' under which the debtor must show that the terms and circumstances of the extension of credit were consistent with the practices of the debtor's industry." (first citing *In re* Dant & Russell, 853 F.2d 700, 704–05 (9th Cir. 1988); then citing *In re* Poff Constr., 141 B.R. 104, 106–07 (W.D. Va. 1991); and then citing *In re* Lodge Am., 259 B.R. 728, 732 (D. Kan. 2001)).

148. *Id.*

149. *Id.*

150. Ayotte & Morrison, *supra* note 104, at 525 (finding that 95% of DIP lenders received a super-priority administrative claim).

151. *See* Zumbro, *supra* note 125, at 13 ("In the DIP financing market, as in the market overall, credit has become more difficult and more expensive to obtain, and those willing to provide credit have sought and received greater protections.").

lender.[152] Under § 364(c), the court may authorize any of the following three protections:[153]

One, the court may grant the lender a super-priority administrative claim.[154] This type of lien has priority over all other administrative claims.[155] Two, the court may grant the lender a lien on unencumbered property of the estate.[156] Unencumbered property is property that is not otherwise subject to a lien.[157] And three, the court may grant the lender a junior lien on encumbered property of the estate.[158] This type of lien is subject to the encumbered property's senior lien.[159] In sum, § 364(c) protects the DIP lender by permitting, with court approval, a super-priority administrative claim and a *non-priming* lien.[160]

3. Super-Priority Administrative With A Priming Lien

The lender, though, may still even seek stronger protection. The court may grant the lender a senior or equal lien on encumbered property.[161] The court may only grant this protection, however, if the debtor in possession can prove that: (i) it is unable to obtain such credit otherwise and (ii) there is adequate protection for the other lien on that encumbered property.[162]

Section 364(d), therefore, protects the DIP lender by permitting, with court approval, a super-priority administrative claim and a priming lien.[163]

In its entirety, § 364 protects what may otherwise seem to be high-risk behavior—lending money to businesses in bankruptcy.[164] By granting high

152. 11 U.S.C. § 364(c) (2012).

153. *Id.*

154. *Id.* § 364(c)(1).

155. *Id.*

156. *Id.* § 364(c)(2).

157. *See Unencumbered*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "unencumbered" as "[w]ithout any burdens or impediments").

158. 11 U.S.C. § 364(c)(3).

159. *See Junior Lien*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "junior lien" as "[a] lien that is subordinate to one or more other liens on the same property").

160. *See* S. REP. NO. 95-989, at 57–58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5843–44 (explaining how subsection (c) protects DIP lenders through super-priority administrative claims and non-priming liens).

161. 11 U.S.C. § 364(d)(1); *see also* Ayotte & Morrison, *supra* note 104, at 525 (finding that 65% of DIP lenders received a priming lien).

162. 11 U.S.C. § 364(d)(1)(A)–(B); *id.* § 361 (providing three options to secure the adequate protection § 364 requires).

163. *See* Paul M. Baisier & David G. Epstein, *Postpetition Lending Under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans*, 27 WAKE FOREST L. REV. 103, 106 (1992) (explaining the granting of a priming lien).

priority and extra security, the Bankruptcy Code encourages lenders to make DIP loans so that debtors in possession have opportunities to restructure.[165] Perhaps unsatisfied by these statutory protections, however, DIP lenders have started to contractually protect themselves further by negotiating aggressive, control-shifting DIP loan provisions.

B. DIP Loan Provisions That Shift Control

DIP lenders traditionally fall into two categories: *offensive* lenders and *defensive* lenders.[166] Offensive lenders are lenders that *did not* have any claims before the bankruptcy or that acquired a claim in anticipation of becoming a DIP lender during the bankruptcy.[167] In other words, these lenders typically *are not* prepetition lenders.[168] If they do have a prepetition claim, they likely bought that claim from another lender anticipating the bankruptcy filing.[169] Offensive lenders typically include hedge funds and private equity funds.[170]

Defensive lenders, on the other hand, are lenders that *did* have a claim before the bankruptcy.[171] In other words, these lenders *are* prepetition lenders.[172] Defensive lenders typically include commercial or investment banks. For both offensive and defensive lenders, control is important.[173] Both lenders want control so that they can influence the bankruptcy process to achieve their goals.[174] Offensive lenders want control to influence sales and equity distributions.[175] Defensive lenders want control to protect their prepetition claims and collaterals.[176]

---

164. *See* George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEVS. J. 19, 49–50 (2004) (explaining how § 364(d) provides some protection to what many perceive as a high-risk loan for lenders).

165. *Cf.* Tung, *supra* note 129, at 30 (explaining that lenders are reluctant to lend to firms in "severe financial distress").

166. Kristin C. Wigness, *Dissecting Strategic DIPs*, LAW360 (July 10, 2013), https://www.law360.com/articles/456089/dissecting-strategic-dips.

167. *Id.*

168. *Id.*

169. *See generally* Eric Winston, *Understanding the Reasons Traders Buy Bankruptcy Claims*, LAW360 (Jan. 8, 2014), https://www.law360.com/articles/498711/understanding-the-reasons-traders-buy-bankruptcy-claims (explaining various reasons why buyers purchase claims against bankrupt companies from other lenders).

170. Wigness, *supra* note 166.

171. *Id.*

172. *Id.*

173. *See supra* Parts II.B.1–5 (explaining the various methods lenders use to exert control over debtors in possession).

174. Wigness, *supra* note 166.

175. *Id.*

176. *Id.*

To gain control, DIP lenders insert a variety of provisions into the loan agreements.[177] I discuss five of them: (i) forum shopping; (ii) management; (iii) contracts and leases; (iv) asset sales; and (v) a plan of reorganization.

1. Forum Shopping

Venue is important because the court must approve any DIP financing agreement.[178] DIP lenders thus may favor venues that are more accommodating to the lenders' interests and direct debtors to file in those venues.[179] Such forum shopping has been criticized extensively, but remains an element of bankruptcy practice.[180] Bankruptcy judges,[181] practitioners,[182] and academics[183] have all recognized DIP lenders' influence over the forum-shopping process.

---

177. It is difficult for a debtor in possession to negotiate against a DIP lender on these provisions. *See* Zumbro, *supra* note 125, at 27 (highlighting that creditors are unlikely to give debtors much leeway). Debtors in possession have little leverage because they desperately need money, and DIP lenders have that money. *See* Ayotte & Morrison, *supra* note 104, at 538 (concluding that creditors, lenders, and unsecured creditors control the reorganization process); Jarrod B. Martin et al., *Freefalling With a Parachute That May Not Open: Debtor-in-Possession Financing in the Wake of the Great Recession*, 63 U. MIAMI L. REV. 1205, 1229 (2009) ("The debtor's need for funds will also weaken its bargaining position."). As the Golden Rule explains: "He who has the gold, makes the rules." G.M. Brod & Co. v. U.S. Home Corp., 759 F.2d 1526, 1532 (11th Cir. 1985).

178. *See* 11 U.S.C. § 105(a) (2012) (granting bankruptcy courts the power to issue any order necessary to carry out Title 11's provisions); *id.* § 105(d)(2)(B)(i)–(vi) (listing the powers of the court in a Chapter 11 proceeding). A debtor can file a bankruptcy case in any district which: (1) contains the debtor's domicile, residence, principal place of business, or principal assets or (2) contains a pending case of the debtor's affiliate, general partner, or partnership. 28 U.S.C. § 1408 (2012).

179. *See, e.g.*, Rosner, *supra* note 125, at 6, 15–16 (explaining that forum shopping has led to an "overwhelming concentration of business cases being filed in Delaware and SDNY" and how judges in these districts repeatedly approve extraordinary terms).

180. *See id.* at 1 ("The consequences of forum shopping are grave."); *see also* Marcus Cole, *"Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1847 (2002) ("This rise of Delaware bankruptcy venue, or *Delawarization* of bankruptcy, has drawn widespread criticism of the current bankruptcy venue provision . . . .").

181. Richard M. Cieri, Judith Fitzgerald & Judith Greenstone Miller, *Panel 1: Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy*, 1 DEPAUL BUS. & COM. L.J. 515, 525 (2003) ("The lenders have a lot to do with [forum-shopping].").

182. *See* Bobby Guy, *Choosing a Venue in Chapter 11 Cases: A Practical View*, MORRISANDERSON (Jan. 18, 2011), http://www.morrisanderson.com/company-news/entry/choosing-a-venue-in-chapter-11-cases-a-practical-view/ [https://web.archive.org/web/20161212220035/http://www.morrisanderson.com/company-news/entry/choosing-a-venue-in-chapter-11-cases-a-practical-view/] ("Because the DIP lender holds the cash, it generally makes the rules about where to file the case. Many are the cases that were prepared for one venue, only to be changed at the last minute to accommodate a newfound DIP lender's demands."); Cieri, Fitzgerald & Miller, *supra* note 181, at 526 (noting that DIP Lenders "are absolutely adamant about where they want a case filed").

183. *Bankruptcy Survival*, *supra* note 129, at 1003 ("DIP lenders may be requiring some borrowers to shop to Delaware or New York as a condition of the loan."); Baird & Rasmussen, *Private Debt and the Missing Lever*, *supra* note 125, at 1240–41 (noting that the DIP lender "has considerable

2. Management

DIP lenders will also require the debtors in possession to hire certain executives or advisers.[184] In particular, a DIP lender may require the debtor in possession to hire a CRO.[185] And if the debtor in possession replaces that CRO, it will be in default on the DIP loan.[186] A DIP lender's control on management can even extend beyond the executive suites and into the boardroom; the DIP loan may stipulate that if the majority of the board changes, then the debtor in possession is in default on the loan.[187]

3. Contracts and Leases

Section 365 of the Bankruptcy Code permits debtors in possession, subject to court approval, to assume or reject executory contracts and unexpired leases.[188] These contracts and leases can greatly impact a debtor in possession's business.[189] The decision to assume or reject thus is a significant decision that the debtor in possession should control.[190]

---

influence" on choosing a venue); James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 177 n.155 (2004) ("My interviewees knew of no case where a DIP lender insisted on a particular place, but they all confirmed that the place of filing was discussed by the DIP and DIP lender and that place of filing would be an important question for the DIP lender."); *see* Cole, *supra* note 180, at 1869 ("Secured creditors, through the power afforded them by their collateral, can influence . . . venue selection.").

184. *See* Ayotte & Morrison, *supra* note 104, at 521 ("DIP loan covenants, for example, routinely include provisions forbidding the debtor from replacing a newly appointed CEO."); Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramírez, *Debtor-in-Possession Financing*, 28 J. BANKING & FIN. 3097, 3107 (2004) (finding that 95% of the DIP loans in their study contained covenants forbidding changes in management); *see, e.g.*, MARCIA L. GOLDSTEIN, DIP FINANCING, PRE-CONFIRMATION SALES AND OUT-OF-COURT RESTRUCTURINGS § III(D) (2015) ("[A] number of recent postpetition financing agreements contain provisions that require the debtor to hire certain advisors or otherwise change their senior management." (first citing *In re* Tronox Inc., No. 09-10156 (Bankr. S.D.N.Y. Jan. 12, 2009); then citing Landsource Cmtys. Dev. LLC, No. 08-11111 (Bank. D. Del. June 9, 2008))).

185. *See* White, *supra* note 183, at 183 ("In some cases the DIP lender insists on the DIP's informal or formal agreement to appoint a person called a Chief Restructuring Officer (CRO)."); Douglas Baird & Martin Bienenstock, *Debtor-In-Possession Financing (Pre-Petition and Lock-Up Agreements)*, 1 DEPAUL BUS. & COMM. L.J. 589, 591 (2003) ("For example, [the] debtor may have to hire a chief restructuring officer as a condition of the DIP loan."); Douglas G. Baird & Robert K. Rasmussen, *Reply: Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 685 (2003) (noting that Worldcom's DIP financing agreement required the board to hire a CRO).

186. *See* Baird & Rasmussen, *Private Debt and the Missing Lever*, *supra* note 125, at 1240 ("[T]he DIP lending agreement can provide that an event of default exists if the CRO is replaced.").

187. *See id.* ("Any change in control, defined to include a new majority of the board, will be a default on the [DIP] loan.").

188. 11 U.S.C. § 365(a) (2012).

189. *See* CONG. OVERSIGHT PANEL, THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 36 n.226 (2009) ("If repudiation or

But DIP lenders are often inserting themselves into the decision-making process.[191] As a condition of the DIP loan, the lender will often require the debtor in possession to assume or reject certain contracts or leases.[192] Failure to consult with the DIP lender about assuming or rejecting a contract or lease is often classified as an event of default, accelerating the balance of the DIP loan.[193]

4. Asset Sales

DIP lenders will also require the debtor to quickly sell certain (or all) assets—primarily, the lenders' collateral—pursuant to § 363.[194] DIP lenders worry that the collateral's value will diminish as the bankruptcy proceeds, so they seek to maximize the value as quickly as possible.[195]

---

cancellation of the contract results in a breach of contract, claims for that breach become unsecured debt of the estate. Debts of the estate, as contrasted with debts of the prepetition debtor, must be paid in full ahead of other unsecured claims." (citation omitted)).

190. *See id.* at 41 (explaining why creditors may want to act in ways that undermine Chapter 11's policy of maximizing the value of the debtor's business).

191. *See id.* at 36 (explaining how a DIP lender has the leverage to control a debtor's contractual decision-making).

192. *See id.* ("Because of its leverage, a DIP lender may have the power to decide which contracts—with suppliers, vendors, dealers, etc.—it wishes the estate to assume and which contracts it wishes the estate to reject.").

193. *E.g.*, *In re* Wet Seal, Inc., No. 15-10081-CSS, 2015 WL 1372974, at *11 (Bankr. D. Del. Feb. 5, 2015) (explaining that the DIP financing agreement provided that it is an event of default if "the Debtors assume, reject, or assign any executory contract or unexpired lease without the prior consultation with the DIP Lender"); *In re* MSR Resort Golf Course LLC, No. 11-10372, 2011 WL 2752261, at ¶ 12 (Bankr. D. Del. 2011) (explaining that it is an event of default if the debtors "assume, reject or assign any material executory contract or lease without consulting in advance and in good faith with the DIP Agent").

194. Kirshner, *supra* note 15, at 538 ("Increasingly, secured creditors have used the control that they have appropriated through the terms of DIP loans to push bankrupt companies into asset sales under Section 363 of the U.S. Bankruptcy Code."). Kenneth N. Klee and Richard Levin likewise note:

> To avoid the risk of diminution in value of their collateral, secured lenders frequently prefer quick sales of substantially all of the debtor's assets to a prolonged chapter 11 case. Financing Orders increasingly contain deadlines for debtors to conduct section 363 sales of substantially all of their assets, often within a few weeks after the filing of a chapter 11 case.

Kenneth N. Klee & Richard Levin, *Rethinking Chapter 11*, 21 NORTON J. BANKR. L. & PRAC. 5 ART. 1 (2012); *see also, e.g.*, Skeel, *Debtor-In-Possession*, *supra* note 10, at 1921 ("American Airlines provided financing under a DIP loan agreement that required an auction of [the debtor's] assets with American as the expected buyer.").

195. Klee & Levin, *supra* note 194.

But while a quick § 363 sale may benefit the lender, it may hurt the estate for at least three reasons. One, it may lower the possibility of a successful reorganization because the business could have used the lender's collateral to generate cash flows and improve the plan's feasibility.[196] The debtor likely needs the lender's collateral to execute its business plan.[197] But if the debtor is forced to sell those assets, it becomes much harder to operate the business and successfully reorganize.[198]

Two, particularly when the lender is the expected buyer, a quick § 363 sale may discourage competitive bidding by imposing short deadlines that do not give other potential buyers an opportunity to conduct diligence.[199] By discouraging bidding, the lender is lowering the sale price of the assets, and thus, reducing the proceeds other creditors will receive.[200]

And three, a quick § 363 sale circumvents a major policy of the Bankruptcy Code.[201] The Bankruptcy Code gives a debtor breathing room to reorganize as the automatic stay prevents creditors from racing to collect on their claims.[202] But these asset sales encourage creditors to act swiftly and in their own self-interests, instead of giving the debtor an opportunity to reorganize.

---

196. *Id.* ("Such forced asset sales may preclude a debtor from formulating alternative business plans.").

197. Warren, REORGANIZING AMERICAN BUSINESSES, *supra* note 2, at 68–69.

198. Klee & Levin, *supra* note 194.

199. Kirshner, *supra* note 15, at 552 ("Without time or access to gather information to improve the accuracy of their offers, [other potential buyers] underbid the DIP lender or refrain from bidding at all."); Klee & Levin, *supra* note 194 ("The estate may also receive lower values from such sales than if the debtor had more time to solicit bids or prospective purchasers had more time to conduct due diligence.").

200. *See* Kirshner, *supra* note 15, at 538, 552 (explaining how DIP lenders strategically manipulate the asset sales process to maximize recovery for themselves at the expense of the DIP's other creditors).

201. *See id.* at 538 ("In doing so, they have undermined the cooperative nature of the bankruptcy law and reintroduced the race for assets among creditors. Obstructing the traditional Chapter 11 process has guaranteed their own recoveries but decreased returns to other creditors.").

202. As the Supreme Court has observed:

> Second, and more important, the preference provisions facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor. Any creditor that received a greater payment than others of his class is required to disgorge so that all may share equally. The operation of the preference section to deter 'the race of diligence' of creditors to dismember the debtor before bankruptcy furthers the second goal of the preference section—that of equality of distribution.

Union Bank v. Wolas, 502 U.S. 151, 160–61 (1991) (quoting H.R. REP. NO. 95-595, at 177–78 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6138).

5. Plan of Reorganization

For a debtor in possession to emerge from Chapter 11, the court must approve a plan of reorganization.[203] This plan is a new contract between the debtor in possession and its creditors.[204] The plan dictates, among other things, how and when the debtor will repay its creditors.[205] The Bankruptcy Code gives the debtor in possession an exclusive period of 120 days after its petition to file a proposed plan.[206] The claimholders and shareholders must then accept the plan within 180 days of the petition.[207] The court can extend or shorten either deadline for cause.[208] If either deadline lapses, then any party in interest may file its own proposed plan.[209]

Getting a favorable reorganization plan proposed and accepted is arguably the most important work the debtor in possession will undertake during bankruptcy. If the plan is accepted, then the company lives to see another quarter.[210] If no plan is accepted or feasible, however, then the court will dismiss the proceeding or convert it to Chapter 7, where the company liquidates and ceases operations.[211]

Because the reorganization plan is so important, it should come as no surprise that the DIP lender will control the plan in two major ways: timing

---

203. 11 U.S.C. § 1141(c) (2012); *see, e.g.*, Press Release, Cenveo, Court Confirms Cenveo's Plan of Reorganization (Aug. 16, 2018) [hereinafter Press Release, Cenveo], http://cenveo.investorroom.com/2018-08-16-Court-Confirms-Cenveos-Plan-of-Reorganization (discussing how the court's approval of the company's reorganization plan will allow it to emerge from bankruptcy).

204. *See In re* MPF Holdings US LLC, 701 F.3d 449, 457 (5th Cir. 2012) ("[C]ourts regularly apply principles of contract interpretation to clarify the meaning of the language in reorganization plans."); Hillis Motors, Inc. v. Haw. Auto. Dealers' Ass'n, 997 F.2d 581, 588 (9th Cir. 1993) ("A reorganization plan resembles a consent decree and therefore, should be construed basically as a contract.").

205. 11 U.S.C. § 1123(a)(1)–(5).

206. *Id.* § 1121(b).

207. *Id.* § 1121(c)(3). While § 1129(a)(8) states that each class of impaired claims or equity interests must accept the plan, § 1129(b) allows the court to confirm a plan despite a class's rejection. *Compare* 11 U.S.C. §§ 1129(a) & (a)(8) ("The court shall confirm a plan only if . . . . With respect to each class of claims or interests—(A) such class has accepted the plan; or (B) such class is not impaired under the plan."), *with id.* § 1129(b)(1) (allowing approval of the plan if all parts of subsection (a) are met, excluding paragraph 8). Such confirmation—over a rejection—is often referred to as a "cramdown." *See generally* Bruce A. Markell, *Fair Equivalents and Market Prices: Bankruptcy Cramdown Interest Rates*, 33 EMORY BANKR. DEVS. J. 91, 93 (2016) ("Cramdown in the historic sense consists of confirmation over the dissent of an *entire* class.").

208. 11 U.S.C. § 1121(d)(1).

209. *Id.* § 1121(c)(2)–(3).

210. *See, e.g.*, Press Release, Cenveo, *supra* note 203 ("The terms of the Plan will enable the Company to exit Chapter 11 with a substantially deleveraged balance sheet and increased liquidity, allowing the Company to focus on its operations and grow its businesses.").

211. 11 U.S.C. §§ 704(a)(1), 1112(b).

and substance.[212] The lender will often shorten the proposal and acceptance deadlines to the detriment of the debtor in possession.[213] With these shortened periods, the debtor in possession has less time to negotiate with its creditors. If the debtor in possession cannot propose a plan or get it accepted by the new lender-imposed deadline, then creditors (such as the DIP lender) may propose their own plans.[214] These plans would likely be less favorable to the debtor in possession.[215]

Further, even if the debtor in possession can file a proposed plan within its exclusivity period, the DIP lender will likely control the contents of the plan.[216] The lender may condition its funding on the court's approval of a plan that the lender endorses.[217]

In sum, DIP lenders are suffocating debtors in possession and stifling their reorganizations.[218] They are influencing which forum the reorganization should occur in and which executives the business should retain.[219] They have the power to assume or reject certain contracts and leases.[220] They are demanding asset sales that benefit themselves, but hurt the rest of the estate.[221] And last, but certainly not least, they are controlling the timing and substance of debtors' reorganization plans.[222]

The above provisions make you wonder who is actually in charge during the bankruptcy proceeding. A theoretical understanding of the Bankruptcy Code would suggest that the debtor is in control. But a practical

---

212. *See* Baird & Rasmussen, *Private Debt and the Missing Lever*, *supra* note 125 ("The DIP financer can control both how long the debtor takes to form a plan and the form the plan ultimately takes.").

213. *Id.*; *e.g.*, *In re* Yellowstone Mountain Club, LLC, No. 08-61570-11, 2008 WL 5869859, at *12 (Bankr. D. Mont. Nov. 26, 2008) (requiring the debtor to file a plan within 90 days of the petition).

214. *See* 11 U.S.C. § 1129(c) (allowing creditors to file a plan if the debtor has not filed a plan and a trustee has been appointed).

215. *See* Baird & Rasmussen, *Private Debt and the Missing Lever*, *supra* note 125, at 1239–40 (highlighting the challenges debtors in possession face when creditors control the planning process).

216. *See* CONG. OVERSIGHT PANEL, *supra* note 189, at 36 (noting that the DIP lender "has the power to shape the proposed plan of reorganization").

217. Tung, *supra* note 129, at 12 n.29 ("For example, it is not uncommon that a DIP loan agreement will prohibit the debtor from filing a plan not approved by the DIP lender.").

218. *See supra* notes 173–76 and accompanying text (explaining that both types of DIP lenders seek control over the debtor's business).

219. *See supra* notes 178–87 and accompanying text (explaining DIP lender forum-shopping practices and management control over the debtor).

220. *See supra* notes 191–93 and accompanying text (explaining that DIP lenders often influence a debtor's decisions regarding contracts and leases).

221. *See supra* notes 194–202 and accompanying text (discussing how DIP lenders will make debtors sell assets in ways that hurt the bankruptcy estate).

222. *See supra* notes 212–17 and accompanying text (explaining how DIP lenders influence the reorganization planning process).

understanding of the industry proves that control has shifted greatly to the lender. What, though, caused this shift? How did we get here?

C. The Great Recession

The Great Recession—the global economic crisis during the late 2000s—greatly impacted the DIP financing industry and, more specifically, the shift in control from debtors to lenders. To explain how, this Section examines how the industry functioned: (1) before the recession, (2) during the recession, and (3) after the recession.

1. Before the Recession

Historically, DIP lenders were typically commercial banks.[223] These lenders were not as aggressive as the current DIP lenders, primarily for two reasons. One, there was a larger market of lenders so DIP lenders had more competition and thus less leverage.[224] If a DIP lender wanted to impose aggressive provisions that stripped control, then the debtor in possession could look elsewhere for a loan.[225] And two, these lenders were simply interested in receiving a return on their loan.[226] Particularly for commercial banks, their core business was lending, a low-risk activity compared to equity investments.[227] In exchange for lending money, lenders would receive a modest return from interest and fees.[228] Lending thus was a small risk that provided small returns, relatively speaking.[229] The traditional lenders appreciated this low-risk, low-return model.[230]

---

223. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 2.

224. *See* Martin et al., *supra* note 177, at 1207 (noting that, before the Great Recession, DIP loans generally saw competition among lenders).

225. *See* Emily Chasan & Caroline Humer, *Bankruptcy Financing Seen More Costly as Wave Hits*, REUTERS (Jan. 12, 2009), https://www.reuters.com/article/us-restructuring-loans/bankruptcy-financing-seen-more-costly-as-wave-hits-idUSTRE50B7KJ20090113 (explaining that securing DIP financing used to be easy for debtors but the financial crisis "changed the rules of the game" by giving lenders the leverage to demand more stringent terms).

226. *See* FINAL REPORT, *supra* note 6, at 77 n.301 (explaining that, unlike before the recession, DIP lenders are now no longer satisfied with low-risk returns).

227. *See* Karen Berman & Joe Knight, *When is Debt Good?*, HARV. BUS. REV. (July 15, 2009), https://hbr.org/2009/07/when-is-debt-good ("[E]quity is riskier than debt.").

228. BAER ET AL., *supra* note 126, at 26.

229. *Id.*

230. *Id.* at 26 n.122.

To be clear, some DIP loan agreements contained a few aggressive provisions even before the Great Recession.[231] But these provisions were limited in number and not as severe as agreements after the Great Recession.[232] If a DIP lender tried to impose a large number of severely aggressive provisions, the court would likely not allow the agreement.[233]

For example, the court in *In re Tenney Village* rejected an aggressive DIP loan because the loan would have given the lender "numerous rights concerning the Debtor's operations and the Chapter 11 reorganization."[234] Such rights provided that:

- the DIP lender "must first approve all specifications for the planned improvements";[235]
- the DIP lender's consultant must directly supervise the debtor in possession's operations and has the "authority to stop the work at any time";[236]
- the debtor in possession must hire a new lender-approved CEO and cannot fire that CEO without the DIP lender's consent;[237]
- the debtor in possession must obtain the DIP lender's approval of its marketing plan and must hire a marketing firm the lender approves;[238]
- the debtor in possession must list the sales price for its condominium units above the minimum threshold the DIP lender establishes;[239] and
- the DIP lender must approve of the debtor in possession's reorganization plan.[240]

The court rejected the agreement because the agreement circumvented the public policy of reorganization under bankruptcy law.[241] Had the

---

231. Some of the cases and research cited throughout the Article preceded the Great Recession. *See, e.g.*, Baird & Rasmussen, *Private Debt and the Missing Lever*, *supra* note 125, at 1210 n.3, 1211 n.5, 1212 n.7 (sourcing cases and research from before the Great Recession).

232. *Compare In re* Tenney Vill. Co., 104 B.R. 562, 567 (Bankr. D.N.H. 1989) (rejecting a pre-recession loan agreement due to the overly aggressive provisions the lender wanted), *with In re* Yellowstone Mountain Club, LLC, No. 08-61570-11, 2008 WL 5869859, at *11–13 (Bankr. D. Mont. Nov. 26, 2008) (accepting a loan agreement with aggressive provisions during the Recession).

233. *In re* Tenney Vill. Co., 104 B.R. at 568–69.

234. *Id.* at 567.

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.* at 568.

241. *Id.* ("The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the

agreement been approved, the lender "would in effect [have] operate[d] the Debtor's business."[242] The debtor should have, and could have, looked for less aggressive lenders.

2. During the Recession

But then the Great Recession began and turned the DIP lending industry on its head. The credit market tightened.[243] All lenders, not just DIP lenders, stopped making loans.[244] One large DIP lender, Lehman Brothers, collapsed and filed for its own bankruptcy.[245] The Lehman Brothers bankruptcy, with over $600 billion in assets, remains the largest bankruptcy filing in U.S. history and is nearly double the next largest (Washington Mutual at $328 billion).[246] The fall of Lehman Brothers sent cautionary shockwaves to other lenders.[247]

Because the market was now barren of lenders, debtors in possession had even less leverage to negotiate with.[248] Supply was low; demand was high. This gave DIP lenders the power and leverage to negotiate for aggressive provisions and exert control over the debtors.[249]

In re Yellowstone Mountain Club, LLC highlights this substantial shift of control.[250] *Yellowstone* combines many of the provisions discussed in

---

benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code.").

242. *Id.*

243. Adam Shell, *Lehman Bros. Collapse Triggered Economic Turmoil*, ABC NEWS, http://abcnews.go.com/Business/lehman-bros-collapse-triggered-economic-turmoil/story?id=8543352 (last visited Dec. 4, 2018).

244. *Id.*

245. *In re* Lehman Bros. Holdings Inc., No. 08-13555, 2008 WL 4902179, at *1 (Bankr. S.D.N.Y Nov. 5, 2008); *see* ROSALIND Z. WIGGINS, THOMAS PIONTEK & ANDREW METRICK, YALE SCH. OF MGMT., THE LEHMAN BROTHERS BANKRUPTCY A: OVERVIEW 2 (Oct. 1, 2014), http://som.yale.edu/sites/default/files/files/001-2014-3A-V1-LehmanBrothers-A-REVA.pdf (providing an overview of the Lehman Brothers bankruptcy).

246. *Top 10 Bankruptcies*, TIME, http://content.time.com/time/specials/packages/completelist/0,29569,1841334,00.html (last visited Dec. 4, 2018).

247. John Garvey, head of the U.S. financial services practice at PricewaterhouseCoopers, explained that the Lehman bankruptcy "shook market confidence to its core and caused people to believe the whole system could blow up." Shell, *supra* note 243.

248. *See, e.g.*, Tung, *supra* note 129, at 6 ("When credit is plentiful and lenders must compete to make loans, borrowers enjoy more bargaining power to minimize constraints. The opposite is true when credit is scarce.").

249. Recall the quote at the beginning of this Part. *See supra* note 123 and accompanying text (providing that Harvey Miller, in a speech at International Institute of Insolvency, articulated that DIP lenders began using "their economic leverage . . . to exert substantial control over the debtor and the chapter 11 case"). Miller's speech was in 2007, the beginning of the Great Recession. *Id.*

250. *In re* Yellowstone Mountain Club, LLC, No. 08-61570-11, 2008 WL 5869859, at *8 (Bankr. D. Mont. Nov. 26, 2008).

Part II.[251] Most noteworthy, the *Yellowstone* provisions are similar to the pre-recession *Tenney* provisions.[252] But whereas the *Tenney* court denied the DIP loan agreement,[253] the *Yellowstone* court approved the financing.[254] In *Yellowstone*, the DIP lender used its economic leverage to negotiate aggressive provisions that stripped the debtor in possession of its control.[255] Such provisions included:

- the debtor in possession must satisfy certain benchmarks, such as collecting dues from at least 80% of club members;[256]
- the debtor in possession must file a proposed reorganization plan within roughly three months of the petition date[257] (as opposed to the four months provided by the Bankruptcy Code);[258]
- the DIP lender must approve of the proposed reorganization plan;[259]
- the debtor in possession must continue to employ its property manager;[260]
- the debtor in possession must agree with the DIP lender on a budget;[261]
- the DIP lender must approve all sales of material assets and related bidding procedures.[262]

Despite these aggressive provisions, the court approved the financing order because failure to do so would have caused "immediate and irreparable harm to the bankruptcy estates."[263] The court reasoned that the debtors were "unable, despite tremendous effort, to obtain any [other] feasible operating credit . . . that would [have] prevent[ed] the Debtors from closing their doors, either now or in the near future."[264]

---

251. *See supra* Part II.B (explaining provisions DIP lenders use to exert authority over debtor's business).

252. *Compare In re* Tenney Vill. Co., 104 B.R. 562, 567–69 (Bankr. D.N.H. 1989) (rejecting the agreement because of the rights given to the lender), *with In re Yellowstone Mountain Club, LLC*, 2008 WL 5869859, at *9–17) (approving aggressive provisions).

253. *In re Tenney Vill. Co.*, 104 B.R. at 568–69, 571.

254. *In re Yellowstone Mountain Club, LLC*, 2008 WL 5869859, at *8.

255. *Id.* at *9.

256. *Id.* at *11.

257. *Id.* at *12.

258. 11 U.S.C. §§ 1121(b), (c)(2) (2012).

259. *In re Yellowstone Mountain Club, LLC*, 2008 WL 5869859, at *12.

260. *Id.*

261. *Id.* at *13.

262. *Id.* at *16.

263. *Id.* at *8.

264. *Id.* at *4.

Thus, and as was common with many DIP financing motions during the Great Recession,[265] the court had its hands tied—which is better, a bad DIP loan or no DIP loan at all? Courts during the Great Recession increasingly answered with the former, approving DIP loans that they otherwise would have considered too aggressive.[266]

On a micro level, the courts may have been right. A bad DIP loan still gives the debtor an opportunity to restructure, whereas the debtor is not afforded that opportunity with no DIP loan.[267] On a macro level, however, by approving bad DIP loans, the courts may have created a standard that prevailed even after the recession.

3. After the Recession

Even after the economy rebounded and the country exited the Great Recession, DIP lenders have continued to impose controlling provisions on debtors in possession.[268] And judges have continued to approve aggressive financing agreements because there are no better alternatives.[269]

Why, though, are there no alternatives? With more credit available in the markets, there should be more competition among lenders.[270] And with

---

265. *See* Tung, *supra* note 129, at 30 (noting how courts became accustomed to "extraordinary provisions such as roll-ups and milestones" during the Great Recession and subsequent years).

266. *Id.*

267. *See id.* at 3 ("Individual judges deciding whether to approve extraordinary provisions face a difficult decision . . . . Judges worry that, if the proposed DIP loan is the only one on offer—as debtors and their prospective DIP lenders typically profess—rejection of the DIP loan would spell doom for the debtor."); *see also, e.g.*, Jamie Santo, *Bankrupt Reichhold Gets Grudging Approval For $94M DIP*, LAW360 (Oct. 2, 2014), https://www.law360.com/articles/583673/bankrupt-reichhold-gets-grudging-approval-for-94m-dip (discussing how a judge authorized harsh DIP loan terms because she thought the debtor had no better alternative).

268. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 ("[O]verall bargaining power still weighs generally in favor of DIP lenders. This has . . . result[ed] in more DIP lender control over the debtor and the Chapter 11 process."); Leake, *supra* note 125 (arguing that DIP financing needs to be "more readily available on terms that support a more predictable and orderly Chapter 11 process that maximizes [the] value of the enterprise"); FINAL REPORT, *supra* note 6, at 77 n.301 ("Regardless of where the debtor gets its DIP financing, the game has dramatically changed . . . . [Lenders often] take control of the debtor, through covenants, deadlines, and default provisions. And these are no mere financial tests to ensure the safety of the lender's repayment." (quoting Coleman, *supra* note 125, at 11)); *Neff*, *supra* note 125 ("[T]he balance of power [has] shift[ed] substantially away from debtors . . . . [T]he changes . . . have greatly restricted debtors' abilities to reorganize.").

269. In 2014, a Delaware bankruptcy judge approved a DIP agreement even though the judge was concerned that the agreement would chill bidding for the debtor's § 363 sale. Santo, *supra* note 267 (quoting Judge Walrath as explaining: "I will reluctantly approve it because I don't think the debtor has any alternative").

270. *See* James McAndrews, Exec. Vice President and Dir. of Research, Fed. Reserve Bank of N.Y., Remarks at the Economic Press Briefing on Student Loans: Credit Growth and Economic Activity After the Great Recession (Apr. 16, 2015), https://www.newyorkfed.org/

more competition, lenders would have less leverage to impose such controlling provisions.[271] Why then is there still a problem? I suggest two reasons.

One, there may not be substantially more competition among DIP lenders. Traditional lenders may be hesitant to re-enter the market, and new lenders may be hesitant to enter the market for the first time. Although the Bankruptcy Code protects DIP lenders with high priority, it still feels risky and counter-intuitive to lend money to bankrupt companies, particularly in light of the Great Recession.[272] Lenders may be more cautious with their money, fearfully anticipating another recession.[273]

Two, there may be more competition among DIP lenders, but practices during the Great Recession established a standard, and courts have not reversed that standard even though the circumstances have changed.[274]

Judge Gerber, while approving an aggressive DIP loan during the Great Recession, explicitly cautioned against this possibility. He warned that aggressive DIP loans, necessary during an economic crisis, should not become precedent and commonplace during a healthier economy:

> I assume, or at least hope that economic conditions in this country, including freeze-ups of the lending markets and the very limited present availability of credit will ultimately improve. What I'm of a mind to recognize and respect now in the way of economic reality will be trumped by the facts on the ground with respect to economic conditions at the time of the next financing I'm asked to approve. And people should be wary of using this case as a precedent in the next one that comes down the road,

---

newsevents/speeches/2015/mca150416.html (explaining that real credit for businesses has recently "attained pre-recession levels").

271. *See, e.g.*, Tung, *supra* note 129, at 6 ("When credit is plentiful and lenders must compete to make loans, borrowers enjoy more bargaining power to minimize constraints. The opposite is true when credit is scarce.").

272. *See id.* at 30 ("DIP financing is crucial for many debtors, but lenders may understandably be hesitant to lend to firms in severe financial distress.").

273. *See* Jonathon M. Trugman, *Wall Street Is Scared of Crisis: Survey*, N.Y. POST (July 18, 2015), http://nypost.com/2015/07/18/wall-street-is-scared-of-crisis-survey/ (explaining that investors hold onto more cash and invest less when they fear economic downturns are likely).

274. Tung, *supra* note 129, at 30 ("It could be that extraordinary provisions such as roll-ups and milestones are here to stay. Judges and lawyers, the repeat players in bankruptcy, may have acclimated to a new status quo . . . ."); Rosner, *supra* note 125, at 16 ("By many accounts, extraordinary DIP financing terms became customary after 2009 even when financing was readily accessible. The Loan Syndication and Trading Association acknowledged that 'to be sure, the terms of DIP loans are customized to the bankruptcy process.'" (footnotes omitted) (quoting Elliot Ganz & Allison Hester-Haddad, *DIP Loans: A Common-Sense Assessment of "Extraordinary Provisions,"* SECURED LENDER, Oct. 2013, at 32, 34)).

> especially if that's the case after the liquidity markets have loosened up.[275]

Though prudent, Judge Gerber's advice may not have been followed.[276] As Professor Tung succinctly put it, "what was once extraordinary may have become commonplace."[277] For whatever reason, DIP financing is still a problem, despite the post-recession economy.

One proposed solution is that courts should simply stop approving these aggressive DIP loans.[278] But when the court is presented with only one option, and the debtor in possession claims it cannot find financing elsewhere, the court has its hands tied.[279] If the court rejects the loan, the debtor in possession will likely be unable to operate and the reorganization will fail.[280] Alternatively, the court can approve the loan, as it has often done.[281] The debtor in possession may lose substantial control rights, but at least there is a chance that the reorganization will still succeed.

Another proposed solution is to amend the Bankruptcy Code. In 2014, the Wall Street Journal asked Paul Leake, then-head of Jones Day's bankruptcy group and now head of Skadden's same group,[282] the one change he would like to make to the Bankruptcy Code.[283] Leake commented that there "needs [to be] changes to ensure that funding is more readily available on terms that support a more predictable and orderly Chapter 11 process that maximizes [the] value of the enterprise."[284] While

---

275. David Griffiths, *Roll-up, Roll-up, Read All About It!*, WEIL: BANKR. BLOG (Oct. 6, 2010), https://business-finance-restructuring.weil.com/dip-financing/roll-up-roll-up-read-all-about-it/.

276. *See* Tung, *supra* note 129, at 30 ("It could be that extraordinary provisions such as roll-ups and milestones are here to stay.").

277. *Id.*

278. *See* FINAL REPORT, *supra* note 6, at 80 ("A court should not approve permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364 in any interim order. In this context, '*permissible extraordinary financing provisions*' include: (i) milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions . . . .").

279. *See, e.g.*, Santo, *supra* note 267 (explaining why one judge reluctantly approved aggressive loan provisions after a financial advisor testified the debtor had no other options).

280. *See* Tung, *supra* note 129, at 3 ("[R]ejection of the DIP loan would spell doom for the debtor.").

281. *See id.* ("[J]udges quite understandably hesitate to reject DIP loans under these circumstances, and instead reluctantly approve the arrangements on the view that the terms were necessary to induce critical lending.").

282. Jodi Xu Klein, *Jones Day's Leake, Laukitis Leave Law Firm for Skadden Arps*, BLOOMBERG (June 23, 2016), https://www.bloomberg.com/news/articles/2016-06-23/jones-day-s-leake-laukitis-said-to-leave-firm-for-skadden-arps; Melissa Daniels, *Skadden Adds Pair of Restructuring Partners from Jones Day*, LAW360 (July 26, 2016), https://www.law360.com/articles/821604/skadden-adds-pair-of-restructuring-partners-from-jones-day.

283. Leake, *supra* note 125.

284. *Id.*

changing the Bankruptcy Code is a viable solution, it may not be the most efficient.[285] Leake admitted that "[t]here is no one change that could accomplish this objective."[286]

Instead of relying on judicial action or legislative changes to the Bankruptcy Code, I propose an alternative solution—one that could be implemented quickly in practice: a government guaranty program. Even if lenders are not exerting substantial control once this Article is published, this Article remains important. The government can implement this proposal during the next economic downturn—when lenders inevitably look to regain control.[287]

To be clear, there is nothing inherently wrong with lenders seeking to exert control over the bankruptcy process. Indeed, it is probably prudent for lenders to act accordingly when their collateral is deteriorating and the debtor is struggling.[288] The lenders have every right—and incentive—to exert as much control as possible.[289]

But the lenders' actions are at odds with the fundamental bankruptcy theory that the debtor—and not the lender—should control the reorganization.[290] And if the government has any interest in protecting the policies of its Bankruptcy Code, then the government should intervene.

III. A SOLUTION: GOVERNMENT GUARANTIES

"I think the U.S. government should guarantee DIPs . . . . That would sort of open up the market."

– Arthur Newman, then Co-head of Restructuring, Blackstone Group (2009)[291]

---

285. *Id.*

286. *Id.*

287. *See supra* Part II.B.2 (explaining how lenders exerted aggressive control over debtors in possession during the Great Recession).

288. *See* BAER ET AL., *supra* note 126, at 39 (explaining that lenders exert control over the bankruptcy process so that they can have "an escape route in the event that the borrower's business falters").

289. *Id.*

290. *See* Harvey R. Miller, *Chapter 11 in Transition: From Boom to Bust and Into the Future*, 81 AM. BANKR. L.J. 375, 390 (2007) (lamenting that creditors effectively neuter "the debtor-in-possession, who is supposed to serve as an independent fiduciary" through controlling loan terms).

291. Caroline Humer & Emily Chasan, *Blackstone Exec Says US Govt Should Back DIP Loans*, REUTERS (Feb. 6, 2009), http://www.reuters.com/article/blackstone-idUSN0646643920090206.

Newman's proposed solution was never implemented; the government never established a program to guarantee DIP loans.[292] Further, the proposal received little consideration in academic literature.[293]

The suggestion was primarily intended for the credit squeeze during the Great Recession.[294] But nearly a decade later, despite a healthier economy, the DIP credit market remains thin, and DIP lending remains problematic.[295] As discussed in the first two Parts of this Article, DIP lending has subverted one of the fundamental theories in corporate reorganizations—the debtor's control over its business.[296]

This Part considers how government guaranties would solve the current problems of DIP lending. Specifically, Section A provides ten elements of a framework that the government could implement to guarantee DIP loans, and Section B describes how such a framework would provide political, economic, and social benefits.

A. A Framework for Government Guaranties

If the government (as it should) implements a DIP guaranty program,[297] it should mirror the program after the government's SBA Loan

---

292. The idea got some attention from bankruptcy practitioners around the time the government bailed out the car industry. *See, e.g.*, Jon Henes, *Why the Feds Should Step into Bankruptcy Loans*, CNBC (Oct. 22, 2008), https://www.cnbc.com/id/27319457 ("[T]he government should implement what I call the Distressed Company Loan Guaranty Program of 2008 (DCLGP) and guaranty DIP loans."). But the closest it came to a legislative proposal was a mention by Mitt Romney, then a failed contender for the 2008 Republican presidential nomination, in a New York Times Op-ed. Mitt Romney, *Let Detroit Go Bankrupt*, N.Y. TIMES (Nov. 18, 2008), https://www.nytimes.com/2008/11/19/opinion/19romney.html ("The federal government should provide guarantees for post-bankruptcy financing . . . .").

293. There is no mention of this proposal in academic journals beyond a brief discussion in a student note. *See* Martin et al., *supra* note 177, at 1222–24 (discussing the arguments for and against government guarantees in brief before concluding that the government would be the "lender of last resort").

294. Humer & Chasan, *supra* note 291 (noting that DIP financing "has been difficult for companies to find since the global credit crisis has caused lenders to pull back on all types of loans").

295. *See supra* Parts II.C.2–3 (detailing the stages of the Great Recession and the remaining provisions from that time).

296. *See supra* Parts I, II (discussing how Bankruptcy Code provisions are designed to benefit the debtor but, in practice, the DIP lender asserts much authority over the business).

297. Just recently, Professor Melissa Jacoby proposed a "Sunlight Fund"—a non-profit enterprise that would work "to advance the goals of corporate bankruptcy by providing an alternative and competing source of capital for businesses in bankruptcy." Jacoby, *supra* note 125, at 1743. Though she does not give details on how, Jacoby proposes that, among other actions, the Sunlight Fund "could reduce the leverage of pre-petition lenders to condition DIP lending on refraining from estate- and transparency-promoting activities, including certain causes of action." *Id.* A government guaranty program would be an ideal method to do so.

Program.[298] Through its SBA Loan Program, the federal government guarantees loans that partner banks make to qualifying small businesses.[299] Because these SBA loan guaranties protect the lenders, the loan agreements can be more favorable for borrowers as they try to grow their businesses.[300]

The same theory applies here. Because government guaranties would protect the DIP lenders, loan agreements can be more favorable for debtors in possession as they try to reorganize. The rest of this Section lays out ten elements of a potential framework for the government to implement.

1. Eligibility

Like with the SBA Loan Program, certain debtors would not be eligible for guaranties.[301] Examples include:

- life insurance companies;[302]
- businesses engaged in pyramid sale distribution plans;[303]
- businesses deriving more than one-third of gross annual revenue from legal gambling activities;[304]
- businesses engaged in illegal activity;[305]
- private clubs or businesses that limit membership for reasons other than capacity;[306]
- government-owned entities;[307] and
- businesses that primarily engage in political or lobbying activities.[308]

---

298. *See* Martin et al., *supra* note 177, at 1223 (mentioning the SBA model but not providing any details on how a similar DIP program would function).

299. *Terms, Conditions, and Eligibility*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/partners/lenders/7a-loan-program/terms-conditions-eligibility (last visited Dec. 4, 2018) [hereinafter *Terms, Conditions, and Eligibility*].

300. Mary Norris & Dave Kaneda, *Expand Your Opportunities: Get to Know the SBA Loan Programs*, WELLS FARGO (May 9, 2014), https://wellsfargoworks.com/credit/video/expand-your-opportunities-get-to-know-the-sba-loan-programs ("SBA loans are a lot like conventional business loans. . . . But because SBA loans are backed by the government, they allow lenders to be more flexible about features like down payments, repayment terms, and collateral.").

301. *SBA Eligibility Questionnaire for Standard 7(a) Guaranty*, U.S. SMALL BUS. ADMIN. 2 (Mar. 4, 2011), https://www.sba.gov/sites/default/files/bank_eligibility_questionnaire_0.pdf.

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.*

2. Guaranty Limit

In the SBA Loan Program, the government only guarantees up to 85% for small loans and up to 75% for bigger loans.[309] In a similar fashion, the government should only guarantee up to 80% of DIP loans. By not guaranteeing the full amount, the government keeps the lender on the hook and prevents the lender from making careless loans.[310]

3. Guaranty Fee

In the SBA Loan Program, the government charges a guaranty fee ranging from 2% to 3.75% depending on the size of the guaranty.[311] Because DIP loans are safer than SBA loans, DIP guaranty fees should be lower.[312] I propose the following guaranty fees, at least as a baseline that the government could raise (or lower) if it wished to do so.

Guaranty Amount	**Fee**
$0 – $99 million	2.00 %
$100 – $499 million	2.50 %
$500 million plus	3.00 %

As long as the fee is larger than 0.5% (the estimated risk of default for DIP loans[313]), the government will earn an expected profit on the loan.[314] By ranging the fees from 2% to 3%, the government earns an additional

309. *Types of 7(a) Loans*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/partners/lenders/7a-loan-program/types-7a-loans (last visited Dec. 4, 2018) (explaining that the SBA guarantees as much as "85% for loans up to $150,000 and 75% for loans greater than $150,000").

310. *See* Kuniyoshi Saito, *Do Credit Guarantees Encourage Moral Hazard?*, WORLD ECON. F. (Nov. 14, 2014), https://www.weforum.org/agenda/2014/11/do-credit-guarantees-encourage-moral-hazard/ (reporting empirical findings that indicate lenders make fewer risky loans when government guarantees cover only 80% rather than 100% of the loan).

311. *Terms, Conditions, and Eligibility*, *supra* note 299.

312. Whereas SBA loans have an estimated 10% default rate, DIP loans have an estimated 0.5% default rate. Emily Maltby, *Small Biz Loan Failure Rate Hits 12%*, CNN MONEY (Feb. 25, 2009), http://money.cnn.com/2009/02/25/smallbusiness/smallbiz_loan_defaults_soar.smb/; WILLIAM FAHY, MOODY'S GLOBAL CORP. FIN., MOODY'S COMMENTS ON DEBTOR-IN-POSSESSION LENDING 4 (Oct. 2008), https://www.moodys.com/sites/products/DefaultResearch/2007300000539803.pdf (using data to suggest "a default probability of about 0.5%" for DIP loans).

313. Fahy, *supra* note 312.

314. *See* Farid Tayari, *Expected Value Analysis*, PENN ST. C. OF EARTH & MIN. SCI., https://www.e-education.psu.edu/eme460/node/730 (last visited Dec. 4, 2018) (defining expected profit as "the probability of receiving a certain profit times the profit").

return (everything over 0.5%) to compensate for the overhead (time and resources) necessary for the program.[315]

The fee structure would also protect the government against any fluctuations of the DIP default rate.[316] A guaranty program could lower the default rate because interest rates would be lower,[317] maturities would be longer,[318] and non-financial defaults would be less likely because the debtors in possession would not have to adhere to strict conditions.[319] If the default rate on DIP loans decreased, the government would earn an even larger expected return.

Alternatively, a guaranty program could increase the default rate because lenders may start making careless loans.[320] Lenders would have less control over the debtors, potentially allowing the debtors to be more reckless with the loan proceeds.[321] Yet even if the default rate on DIP loans quadruples from 0.5% to 2%, the government would still earn a profit on its guarantees because of the proposed fee schedule ranging from 2% to 3%.[322]

4. Partnership

The government should partner with banks and other lenders, just like it does in the SBA Loan Program.[323] To obtain an SBA loan, a small

---

315. *See id.* (explaining that, on average, repeated investments with a given level of risk will produce a net gain).

316. *See* Ashoka Mody & Dilip Patro, *Methods of Loan Guarantee Valuation and Accounting* 16 (World Bank Grp., Departmental Working Paper No. 15350, 1995), http://siteresources.worldbank.org/INTGUARANTEES/Resources/Methods_of_Loan_Guarantee_Valuationand_Accounting.pdf ("Pricing of guarantees is highly desirable because it . . . shifts the cost of guarantees to the consumers of services provided rather than to the general taxpayer, and . . . . cover[s] downside risk . . . .").

317. Norris & Kaneda, *supra* note 300.

318. *See Fahy*, *supra* note 312, at 6–7 (discussing how DIP loans that mature before a debtor reorganizes increase default risk).

319. *Id.* at 7 (cautioning that the complex reorganization plans "can increase the risk of DIP loans"); *see infra* text accompanying notes 364–69 (explaining how only loans without aggressive terms would qualify for a guaranty).

320. *Cf.* Chris Hurn, *Careless SBA Lending Tells Same Old Story*, HUFFINGTON POST (June 30, 2015), https://www.huffingtonpost.com/chris-hurn/careless-sba-lending-tell_b_7689892.html (opining that the SBA's practice of encouraging "small business lenders to offer government guaranteed 7(a) loans in ever-larger amounts with yet smaller collateral contributions from borrowers" amounts to "irrational exuberance").

321. *Cf. id.* (differentiating between using loan proceeds "for business acquisitions, partner buyouts, working capital loans, and so forth," and "fixed assets like commercial property and heavy equipment," insinuating that the former are proper places to spend loan proceeds, and the latter are not).

322. *See* Tayari, *supra* note 314 (explaining why, averaged over a large number of investments, an investor will earn an overall profit so long as expected profits exceed expected costs).

323. Brendan Kiernan, *SBA 7(A) Loan Program: An Overview*, MIRUS CAP. ADVISORS, (Apr. 16, 2010), http://merger.com/sba-7a-loan-program-an-overview/.

business applies for the loan from a lender that has partnered with the government.[324] The lender then applies to the government for its guaranty, declaring that it will only make the loan if it obtains a guaranty.[325]

In a similar fashion, a debtor in possession would apply for a DIP loan from a DIP lender that has partnered with the government. A list of potential partners include: Wells Fargo, JPMorgan, Bank of America, PNC Bank, and U.S. Bank.[326] Each of those lenders are SBA partners and thus are familiar with the guaranty process.[327] The DIP lender, in turn, would apply to the government for its guaranty.

DIP lenders, like SBA lenders, that wish to partner with the government must meet the following four requirements:

> [H]ave a continuing ability to evaluate, process, close, disburse, service and liquidate small business loans; be open to the public for the making of such loans (and not be a financing subsidiary, engaged primarily in financing the operations of an affiliate); have continuing good character and reputation; and be supervised and examined by a state or federal regulatory authority, satisfactory to SBA. [328]

If a partner DIP lender becomes reckless in its underwriting, then the lender could face civil liability, criminal liability, or both.[329]

---

324. *Id.*

325. *Id.* ("When a lending partner applies to SBA for a guaranty on a proposed loan, it must certify that it would only make the loan if SBA guarantees it." (emphasis omitted)).

326. *100 Most Active SBA 7(a) Lenders*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/article/2017/oct/01/100-most-active-sba-7a-lenders (last visited Dec. 4, 2018).

327. *Id.*

328. ROBERT JAY DILGER, CONG. RES. SERV., R41146, SMALL BUSINESS ADMINISTRATION 7(A) LOAN GUARANTY PROGRAM 6–7 (2013), http://media.cmgdigital.com/shared/news/documents/2013/04/05/CRS-SBA_Loan_Guaranty_2013.pdf; *see also Why Become an SBA Lender?*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/category/lender-navigation/working-with-sba/become-sba-lender (last visited Dec. 4, 2018).

329. For example, PNC Bank paid the federal government $9.5 million to settle claims under the False Claims Act for "failing to engage in prudent underwriting practices for loans guaranteed by the U.S. Small Business Administration." Press Release, U.S. Attorney's Office, Dist. of Md., PNC Bank to Pay $9.5 Million for Failing to Engage in Prudent Underwriting Practices for Loans Guaranteed by the U.S. Small Business Administration (Aug. 16, 2016), https://www.justice.gov/usao-md/pr/pnc-bank-pay-95-million-failing-engage-prudent-underwriting-practices-loans-guaranteed-us.

5. Disclosure

When a debtor in possession asks the court to approve a DIP loan, the debtor in possession must summarize all material and essential terms of the loan agreement.[330] This procedural rule saves the court time and effort because it does not have to comb through hundreds of pages of a DIP loan agreement and prevents the DIP lender or debtor in possession from hiding material provisions that could hurt the estate.[331]

In a similar fashion, if a DIP lender is seeking a government guaranty, the government should require the DIP lender to disclose the material and essential terms of the agreement. The government would require the DIP lender in its application for a guaranty to disclose, either in a summary or a list, the following terms: interest rate, maturity, priority, liens, and any material covenants and conditions. This system would prevent the government from wasting time and resources identifying such provisions in the agreement. Misrepresenting such disclosures would result in a penalty (e.g., a fine, a civil fraud lawsuit, a criminal fraud lawsuit, or some combination thereof).

6. Maturity

The DIP loan must have a maturity date of at least 9 months, but preferably at least 12 months.[332] In the SBA Loan Program, the government will guarantee shorter loans for small businesses. But shorter loans, such as loans with maturities of less than six months, are problematic for a debtor in possession because the short maturity does not give the debtor sufficient

---

330. FED. R. BANKR. P. 4001(c)(1)(B). Federal Rule of Bankruptcy Procedure 4001(c) specifically provides:

> The motion shall . . . begin with a concise statement of the relief requested . . . that lists or summarizes, and sets out the location within the relevant documents of, all material provisions of the proposed credit agreement and form of order, including interest rate, maturity, events of default, liens, borrowing limits, and borrowing conditions.

Id.

331. *See* H.R. REP. NO. 95-595, at 409 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6365 (clarifying that the depth of disclosures required depend on a balance of practical measures such as the "cost of preparation" and the speed of plan confirmation).

332. *See* Zumbro, *supra* note 125, at 14 (explaining why DIP loan terms of less than one year are unduly detrimental to debtors).

time to reorganize.[333] As a result, courts are starting to push for DIP loans to be closer to 12 months.[334] The government should require likewise.

7. Interest Rate

Prior to the Great Recession, DIP loans typically had an interest rate about 2–4% above LIBOR.[335] During the Great Recession, DIP loans became more expensive; rates ranged from 6% to 10% above LIBOR, with some of the most expensive loans priced at 12% above LIBOR.[336] Recall the earlier 2008 *Yellowstone* case.[337] In addition to exerting substantial control over the debtor through aggressive provisions, the DIP lender received interest 12% above LIBOR.[338]

Pricing now, in a post-recession economy, has seemed to improve somewhat.[339] Rates now appear to range from 4% to 7% above LIBOR.[340]

---

333. *See id.* ("The recent trend is for maturities of one year or less. These shorter-maturity DIP facilities may not provide the debtor company with enough time to reorganize and emerge from bankruptcy."); Alarna Carlsson-Sweeny, *DIP Financing: A Rough Road to Recovery*, PRAC. L., July 28, 2009, THOMSON REUTERS, Doc. No. 2-386-7115, http://us.practicallaw.com/2-386-7115 (quoting a bankruptcy partner who said that "[e]xcessively short loan maturities tie up the debtor in worrying about securing more DIP financing when it should be concentrating on how to reorganize and exit bankruptcy").

334. Carlsson-Sweeny, *supra* note 333 (quoting a bankruptcy partner who said that "judges are starting to push for loans around the 12-month mark").

335. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 ("Interest rates on DIP loans historically were about 200 to 400 basis points above LIBOR."); *see also* Chad Langager, *What is a Basis Point (BPS)?*, INVESTOPEDIA (Dec. 15, 2017), https://www.investopedia.com/ask/answers/what-basis-point-bps/ (explaining that 100 basis points equal 1%).

336. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 ("However, in 2008 and 2009, pricing increased to the range of 600 to 1000 basis points or more above LIBOR. At the peak of the credit crunch, some DIP loans were priced at 1200 basis points above LIBOR."); *see also* Tina Peng, *$400M DIP Financing Approval for General Growth*, LAW360 (May 14, 2009), https://www.law360.com/articles/101569/400m-dip-financing-approved-for-general-growth (noting that General Growth's lenders set the interest rate on its 2009 DIP loan at one month LIBOR plus 1,200 basis points).

337. *In re* Yellowstone Mountain Club, LLC, No. 08-61570-11, 2008 WL 5869859, at *11 (Bankr. D. Mont. Nov. 26, 2008).

338. *Id.* Interest on the 2008 *Yellowstone* DIP loan was set at 15%, *id.*, whereas one-year LIBOR was set at 3.1%. *US Dollar LIBOR Rates 2008*, GLOBAL-RATES.COM, https://www.global-rates.com/interest-rates/libor/american-dollar/2008.aspx (last visited Dec. 4, 2018).

339. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 ("Rates are now well off their 2009 peak . . . .").

340. *Id.* (noting that rates are now "averaging LIBOR plus 675 basis points for term facilities"); *see also*, *e.g.*, U.S. SEC. & EXCH. COMM'N, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934: VANGUARD NAT'L RES. LLC (2017), https://www.sec.gov/Archives/edgar/data/1384072/000138407217000035/form8-k020217.htm (explaining that the interest rate on the DIP credit agreement was set at the LIBOR rate plus 5.50%); U.S. SEC. & EXCH. COMM'N, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES

Though this range is partly better than rates during the Great Recession, the rates are still more expensive than they were prior to the recession.[341] Further, these rates are similar to rates imposed on risky loans; they do not represent rates that would typically accompany safe loans with a default rate of 0.5%.[342]

To guarantee a DIP loan, the government should require that the loan's interest rate revert back to pre-recession norms (2–4% above LIBOR).[343] The government should not mandate an interest rate; let the market compete. But the government should put a ceiling on such rates at 4% above LIBOR—or preferably, at a comparable rate using a different benchmark since LIBOR is being phased out.[344] By relating the ceiling to a benchmark rate, the government would allow the interest rate to adjust to economic conditions and market standards.[345]

That said, the government could allow slightly more expensive DIP loans (e.g., five points above LIBOR) in the early stages of this guaranty program if doing so would encourage new lenders to take advantage of the program. Once new lenders enter the market and the market stabilizes, the government could then implement the "LIBOR plus four" ceiling more strictly.

EXCHANGE ACT OF 1934: PERFORMANCE SPORTS GRP. (2016), https://www.sec.gov/Archives/edgar/data/1514242/000110465916154445/a16-20430_18ka.htm (discussing the interest rate, which was set at LIBOR plus 4.50%); U.S. SEC. & EXCH. COMM'N, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934: AÉROPASTALE, INC. (2016), https://www.sec.gov/Archives/edgar/data/1168213/000114036116063876/form8k.htm (discussing the LIBOR rate plus 5.0%); U.S. SEC. & EXCH. COMM'N, CURRENT REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934: THE WET SEAL, INC. (2015), https://www.sec.gov/Archives/edgar/data/863456/000119312515096942/d890614d8k.htm (discussing a flat 8.0% rate).

341. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1 (noting that pre-recession interest rates were approximately 200 to 400 basis points above LIBOR).

342. Fahy, *supra* note 312, at 4 (using data to suggest "a default probability of about 0.5%" for DIP loans).

343. KEY DEVELOPMENTS AND TRENDS IN DIP FINANCING, *supra* note 9, at 1.

344. Lenders and debtors would be well-advised to start using a different benchmark in their loans because LIBOR is being phased out and will not exist by 2021. David Reid, *This Scandal-Hit Interest Rate Used to Set Mortgages Is to End in 2021*, CNBC (July 27, 2017), https://www.cnbc.com/2017/07/27/scandalous-libor-rate-to-end-in-2021.html.

345. *See* Akin Oyedele, *The Fed Just Raised Interest Rates Again — Here's How It Happens and Why It Matters*, BUS. INSIDER (Sept. 26, 2018), https://www.businessinsider.com/how-the-fed-raises-interest-rates-2017-12 (explaining how the Federal Reserve changes its benchmark interest rate to respond to different economic conditions).

8. Priority

Recall that § 364 of the Bankruptcy Code grants administrative or super-administrative priority to postpetition credit.[346] DIP lenders predominantly receive super-administrative priority for their loans.[347] Such priority requires the DIP lender to be paid back before other administrative claimants (such as the debtor's bankruptcy professionals and other specific creditors).[348]

To be eligible for a government guaranty, a DIP loan should only be granted administrative priority and not super-administrative priority. DIP lenders that have a guaranteed loan should not be concerned with the order the debtor repays its lenders.[349] Whether it is from the debtor in possession or the government, the lender will still be repaid in full—or at least up to the 80% that the government guarantees.[350]

Only permitting administrative priority would also result in a more efficient judicial process. Recall that the court must approve the DIP loan under § 364.[351] To grant administrative priority, the court requires a lower standard than if it was to grant super-administrative priority.[352] Debtors in possession would spend less time and resources trying to meet this higher standard, and creditors would spend less time and resources objecting.[353] The whole estate thus would benefit because estate resources would be saved.[354]

---

346. *See supra* Part II.A (explaining § 364 and the three postpetition priority categories).

347. *See* Ayotte & Morrison, *supra* note 104, at 525 (finding that 95% of DIP lenders received a super-priority administrative claim).

348. 11 U.S.C. § 364(a)–(b) (2012).

349. *See* Martin et al., *supra* note 177, at 1222 (arguing that government guaranteed DIP loans would "drastically reduce[] the risk for banks").

350. *See supra* Part III.A.2 (proposing the government should only guarantee up to 80% of DIP loans).

351. *See supra* Part II.A. (noting that the court has authority over ultimate approval of the DIP loan).

352. Administrative priority is the default for postpetition credit. 11 U.S.C. § 364(a)–(b); *see also* S. REP. NO. 95-989, at 57–58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5843–44 (explaining that subsection (c) should only be used if subsections (a) and (b) cannot be used). Super-administrative priority, on the other hand, requires the debtor to prove that it was "unable to obtain unsecured credit" as an administrative expense. 11 U.S.C. § 364(c).

353. *See supra* Part II.B.5 (discussing the inefficiencies of the current Bankruptcy Code).

354. *See supra* Part II.B.5 (describing how the current system harms the bankruptcy estate).

9. Collateral

Recall that a majority of DIP lenders receive a priming lien on collateral that another creditor has already secured.[355] Such priming harms the estate's creditors, particularly the primed creditors.[356]

To be eligible for a government guaranty, the DIP lender cannot prime any other liens. In other words, the DIP lender cannot take a security interest that is senior to another perfected security interest.[357] Rather, the lender may take a lien on any of the debtor in possession's unencumbered assets or may take a junior lien on any encumbered assets.[358]

Just as with priority, not permitting priming liens would also result in a more efficient judicial process. When a lender seeks to prime a lien, the lender must prove that the prior lien is adequately protected.[359] Proving this protection requires time and resources, and the primed creditor often objects.[360] Thus, just as with priority, the whole estate would benefit by not permitting priming liens because this saves estate resources.[361]

To be clear, the government should encourage the DIP lender to take all the collateral that it can get without priming other creditors. The government's guaranty is not a substitute for collateral.[362] An absence of available collateral, though, should not be a sufficient reason for the government to deny a lender's guaranty request.[363]

---

355. Ayotte & Morrison, *supra* note 104, at 525 (finding that 65% of DIP lenders receive a priming lien).

356. *See* Martin et al., *supra* note 177, at 1213 (noting that court-granted priming liens "place DIP lenders in front of the secured creditors").

357. *See id.* at 1213 n.53 (explaining that a priming lien by definition "attaches in front of prepetition secured creditors").

358. *See supra* Part II.A.3 (explaining how a DIP lender can currently take a security interest that is senior to another perfected security interest); 11 U.S.C. § 364(c)(2)–(3) (authorizing non-priming liens when the trustee is unable to obtain unsecured credit).

359. 11 U.S.C. § 364(d)(1)(B).

360. *See supra* Part I.B.2 (noting that creditors can object before the court).

361. *See supra* Part III.A.8 (explaining how only permitting administrative priority would save both creditors and debtors time and resources).

362. *See* CMTY. AFFAIRS DEP'T, OFF. OF THE COMPTROLLER OF THE CURRENCY, CMTY. DEVS. INSIGHT, BANKERS' GUIDE TO THE SBA 7(A) LOAN GUARANTY PROGRAM 3 (2014), https://www.occ.gov/topics/community-affairs/publications/insights/insights-bankers-guide-sba7a-loan-program.pdf ("The SBA guaranty is not a substitute for collateral, and the SBA expects each loan to be prudently secured.").

363. *See id.* ("The SBA does not, however, decline requests to guarantee loans if the only unfavorable factor is insufficient collateral, provided the borrower offers all collateral it has available to secure the loan.").

10. Covenants and Conditions

Perhaps most importantly, the DIP loan cannot take away important control rights from the debtor in possession. Ideally, the DIP loan should not have any of the aggressive provisions discussed earlier. The DIP lender should not: (i) direct the debtor to file in a certain venue,[364] (ii) require the debtor to hire or fire certain management,[365] (iii) determine which contracts and leases the debtor will assume,[366] (iv) influence asset sales,[367] or (v) dictate the timing or substance of the reorganization plan.[368]

But the government may, depending on the circumstances and at its own discretion, still guarantee a loan if it has aggressive provisions, provided that the provisions are minimal and not significant. It is important that the debtor in possession maintains its control rights, as the Bankruptcy Code prescribes.[369]

Critics will argue that this proposed solution risks taxpayers' hard-earned money—why throw good money at bad businesses? Critics of the SBA program share similar thoughts—why lend money to a risky business if the private market would not lend to that business without a guarantee?[370] Critics, likewise, argue that the government is losing money through the SBA program.[371]

But such worry is unnecessary for this proposal. As discussed earlier, and though it may seem counter-intuitive, DIP loans are extremely low-risk

---

364. *See supra* notes 178–83 and accompanying text (explaining the current use of jurisdiction by DIP lenders as a tactic).

365. *See supra* notes 184–87 and accompanying text (noting the current ability of lenders to assert authority over the management team of the debtor's business).

366. *See supra* notes 191–93 and accompanying text (highlighting that DIP lenders currently exercise authority over contracts the debtor enters into).

367. *See supra* note 194 and accompanying text (discussing the ability DIP lenders currently have to require debtors to sell assets).

368. *See supra* notes 212–17 and accompanying text (explaining that DIP lenders will insert their authority into important aspects of the reorganization plan).

369. *See* 11 U.S.C. §§ 1107–08 (2012) (providing that the debtor has the right to continue operating its business during a Chapter 11 bankruptcy); H.R. REP. NO. 95-595, at 233 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6192 (discussing generally the benefits of a debtor remaining in control of the business).

370. Ray Hennessey, *Why the SBA Should Be Abolished*, ENTREPRENEUR (Sept. 4, 2013), https://www.entrepreneur.com/article/228186 ("[The SBA program] lets through ideas that the marketplace has already determined won't fly.").

371. Lynn Hulsey & Ken McCall, *Taxpayers Paid $1.3B for Loan Defaults*, COLUMBUS DISPATCH (Apr. 14, 2013), http://www.dispatch.com/content/stories/business/2013/04/14/taxpayers-paid-1-3b-for-loan-defaults.html ("Lax federal oversight allowed lenders to repeatedly make bad loans to small businesses under a government program that has cost taxpayers $1.3 billion since 2000 on defaulted loans, a *Dayton Daily News* investigation found.").

because of the administrative priority they receive.[372] As a result, DIP loans have an estimated 0.5% default risk,[373] as opposed to the much higher default risk for SBA loans.[374] In other words, for every 200 DIP loans, only one is likely to default.[375] For every 200 SBA loans, though, 10 to 20 of them are likely to default.[376]

A government guaranty program thus would be of little risk to taxpayers. Under the fee schedule this Article proposed earlier, the government would likely earn enough money solely from guaranty fees to pay for any defaults.[377] Taxpayers would pay nothing.

While the solution of guaranties seems to make sense for the government, the government is not the only party involved. For this solution to be implemented, it must make sense for the lenders and borrowers as well. Why would a lender pay the proposed guaranty fee, just so it can charge a lower interest rate and take a lower priority with less control? This solution is not necessarily for the lenders currently in the market. This solution is for other lenders who need encouragement to enter the market. Their entrance would provide competition among all DIP lenders and force the current lenders to be less aggressive.

These new lenders can also pass the guaranty fee onto the borrowers, the debtors in possession.[378] The debtors in possession would likely have no problems paying a small fee if it meant they would remain in control of their operations and important business decisions. In the aforementioned

---

372. *See* Lynn Adler, *DIP Loans to Distressed Companies Mount with Bankruptcies*, REUTERS (Apr. 28, 2016), http://www.reuters.com/article/us-diploans-mount-idUSKCN0XP2AX (quoting David Keisman, a senior vice president and default analyst at Moody's Investors Service, who explained that "DIP[] [loans] are a well structured, superpriority asset class that has investment-grade characteristics in terms of loss and default performance").

373. Fahy, *supra* note 312 (using data to suggest "a default probability of about 0.5%" for DIP loans).

374. SBA loans are probably about 10 to 20 times as risky as DIP loans. *Compare* Fahy, *supra* note 312 (suggesting a default probability risk as low as 0.5% for DIP loans), *with* Tom Steward, *What Happens When an SBA-Backed Loan Goes Bad?*, WATCHDOG (Mar. 30, 2015), https://www.watchdog.org/national/what-happens-when-an-sba-backed-loan-goes-bad/article_3ab1b7be-d2cf-5bc4-9ff4-fed8ade49a67.html ("The SBA doesn't advertise the default rate for loans that fail, though in recent years the figure appears to average 4 percent to 5 percent."), *and* Maltby, *supra* note 312 (reporting that the SBA loan default rate was either 10% or 11.9% in 2008). The SBA does not publish the default rate, but studies and estimates range from about 5–10%, with one study finding that nearly 12% of SBA loans defaulted in 2008. *Id.*

375. Fahy, *supra* note 312.

376. Steward, *supra* note 374; Maltby, *supra* note 312.

377. *See supra* Part III.A.3 (explaining the proposed fee schedule and calculations).

378. This policy is similar to the SBA policy; SBA lenders can pass the guaranty fees on to their small business borrowers. *SBA Loan Rates: Everything You Need to Know*, FUNDERA, https://www.fundera.com/business-loans/guides/sba-loan-rates (last updated Nov. 19, 2018) ("The lender initially pays the guarantee fee, but they usually pass that expense on to the borrower . . . .").

Yellowstone case, for example, the DIP lender stripped the debtor in possession of a variety of important control rights in exchange for the $19.75 million loan.[379] For just $395,000, the debtor in possession would have retained those rights.[380] The debtor could have had a longer time to file a reorganization plan with more control over the substance of the plan, and it could have had more control over its management and asset sales.[381]

Further, the debtor in possession would most likely pay a lower interest rate on the guaranteed loan than if the loan was not guaranteed.[382] The debtor in possession thus would save money on lower interest expenses.[383]

B. The Benefits of Government Guaranties

Despite being low-risk for the government, guaranteeing DIP loans would generate high rewards.[384] Specifically, guaranteeing DIP loans would result in political, economic, and social benefits.

First, this Article's proposal would realign bankruptcy theory with bankruptcy practice. As discussed throughout the Article, a divide currently exists between theory and practice because of the DIP lending market.[385] The government has an interest in shrinking that divide so that bankruptcy practice functions as the legislature intended it to function.[386] To be guaranteed under this suggested framework, DIP loans would not be able to contain many of the aggressive provisions that currently contribute to the theory-practice divide.[387] Further, government-guaranteed DIP loans would

---

379. *In re* Yellowstone Mountain Club, LLC, No. 08-61570-11, 2008 WL 5869859, at *9, *12–16 (Bankr. D. Mont. Nov. 26, 2008).

380. *See supra* Part III.A.3 (proposing a 2% fee for a loan of this amount).

381. *See supra* Part III.A.6 (explaining that the proposed system would give a debtor more time to reorganize and prohibit lenders from seizing important control rights).

382. Interest rates compensate for, among other things, the risk associated with repayment. Because guaranteed loans come with less repayment risk, lenders would be willing to take lower interest rates. *See* MURRAY N. ROTHBARD, MAN, ECONOMY, AND STATE WITH POWER AND MARKET 1084 (2d ed., Ludwig von Mises Inst. 2004) (explaining how a risky borrower must "pay high interest rates to compensate for the added risk").

383. *See* BAER ET. AL., *supra* note 126, at 26 n.122 (explaining that borrowing from a lender who offers a lower interest rate is a less expensive option for debtors in possession).

384. *Cf.* CONG. OVERSIGHT PANEL, *supra* note 189, at 36 n.225 ("A liquid market for DIP loans would temper the DIP lender's leverage in the reorganization process by providing the debtor with alternative offers for DIP financing.").

385. *See, e.g.*, *supra* notes 51–53 and accompanying text (explaining how in theory Chapter 11 lets debtors remain in control of their businesses). *But see supra* Part II.B (explaining how DIP lenders subvert this system in practice by using loan terms that shift control to them).

386. *See supra* notes 87–94 and accompanying text (explaining that Congress intended to allow the debtor to remain in control as part of the 1978 Reform Act).

387. *See supra* Part II.B (detailing common provisions DIP lenders use to assert authority over debtors' businesses).

encourage more lenders to enter the market, generating more competition among lenders and more leverage for debtors to negotiate against these aggressive provisions.[388]

Second, the government would reap direct and indirect economic benefits if it implemented this Article's proposal. As mentioned earlier, the government would charge a fee on its guaranties.[389] As long as the income from fees is greater than the expenditures to reimburse banks for defaults, the government would earn a positive return on its investment.[390] Because the default rate is so low for DIP loans, the government is very likely to earn a return from its fees.[391]

On top of the income directly earned from fees, the government would also benefit indirectly from corporate income taxes. Through its guaranties, the government would be supporting companies in their efforts to reorganize effectively rather than liquidate. If debtors in possession are able to successfully and efficiently reorganize then the companies will be able to operate after exiting bankruptcy protection.[392] Once operating outside of bankruptcy, the companies would resume paying corporate income taxes.[393] The government would not receive any taxes, on the other hand, from companies that liquidated and ceased operations.[394]

Last, by fixing this bankruptcy problem, the government would produce societal benefits.[395] Perhaps most tangibly, the government would help preserve jobs.[396] A successfully reorganized company employs more people than a liquidated company that ceases to exist.[397]

---

388. CONG. OVERSIGHT PANEL, *supra* note 189, at 36 n.225.

389. *See supra* Part III.A.3 (explaining proposed government guaranty fee system).

390. *See supra* notes 313–14 and accompanying text (explaining the minimum fee the government must collect to earn a profit from providing the guaranty).

391. *See supra* note 315 and accompanying text (explaining why a 2% to 3% guaranty fee would produce a net profit for the government at current DIP default rates).

392. *See* H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179 ("The purpose of a business reorganization case . . . is to restructure a business's finances so that it may continue to operate . . . .").

393. *See id.* (explaining that reorganization allows businesses to return to a viable state, whereas liquidated businesses are no longer viable); *Business Taxes*, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/business-taxes (last updated Apr. 12, 2018) ("All businesses except partnerships must file an annual income tax return.").

394. *See* H.R. REP. NO. 95-595, at 220 (noting that unlike liquidation, reorganization potentially preserves jobs and corporate income producing assets); *see also Business Taxes*, *supra* note 393 (noting that both corporate and employee income are taxable).

395. *See* Jacoby, *supra* note 125, at 1722 ("Business restructuring and failure produce ripple effects in communities and society at large."); *id.* at 1723 ("At the very least, the public has a stake in who makes the key decisions in corporate bankruptcy and whether that process comports with basic constitutional and democratic norms.").

396. H.R. REP. NO. 95-595, at 220 ("The purpose of a business reorganization case . . . is to restructure a business's finances so that it may continue to operate, *provide its employees with jobs*, pay

If this Article's solution involves little risk, yet generates substantial benefits, why has it not been implemented yet? This question is a typical objection by economists and scholars that strictly adhere to the efficient market theory—if the proposed solution was truly a good idea, then someone would have implemented it already.[398]

Aside from what I think about the objection in general,[399] there is a legitimate reason why no one has yet implemented a guaranty program for DIP loans. Implementing such a framework would require a third party (the government) to enter a two-party transaction (between the DIP lender and the debtor in possession).[400] Thus it is possible, and even likely, that as an outside third party the government is not fully aware of the problems between the two other parties.[401]

And no party has an incentive to inform or lobby the government for help. The current DIP lenders have no incentive because they benefit from their aggressive DIP loans and their substantial control over the

---

its creditors, and produce a return for its stockholders." (emphasis added)); *see also* NLRB v. Bildisco, 465 U.S. 513, 528 (1984) (explaining that the main purpose of reorganization is to preserve jobs and economic resources), *superseded by statute*, Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, *as recognized in In re* Am. Provision Co., 44 B.R. 907, 908 (Bankr. D. Minn. 1984).

397. H.R. REP. NO. 95-595, at 220 ("It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets."). Newman, the Blackstone executive discussed earlier, suggested that the government could sell a guaranty program to taxpayers "by saying we're saving jobs." Humer & Chasan, *supra* note 291.

398. This objection parallels—or stems from—a classic economics joke where an economist and a friend are walking down the street. Larry Swedroe, *The Twenty Dollar Bill*, ETF (Mar. 16, 2004), https://www.etf.com/sections/features/123.html. The friend notices a $20 bill on the ground, and the friend proceeds to tell the economist about it. *Id.* The economist replies, "[c]an't be. If there was a $20 bill on the ground, somebody would have already picked it up." *Id.*

399. One problem with this "efficient market" objection is that a strict following of the theory would result in the end of progress and innovation. *See* Trevir Nath, *Investing Basics: What is the Efficient Market Hypothesis, and What Are its Shortcomings?*, NASDAQ (Oct. 15, 2015), https://www.nasdaq.com/article/investing-basics-what-is-the-efficient-market-hypothesis-and-what-are-its-shortcomings-cm530860 (arguing the efficient market hypothesis fails to account for the impact of volatility, and thus investors who slavishly follow it miss opportunities to identify mispricing and progressively improve their investment strategies). Every great idea becomes worthless. *See* Lars Lofgren, *Why Your Idea is Worthless*, http://larslofgren.com/marketingbasics/why-your-idea-is-worthless (last visited Dec. 4, 2018) (arguing that all ideas are worthless if no one executes them). If the idea was truly great, it would have already been implemented. Someone, though, must be first. Someone has to be the first person to pick up the $20 bill. Swedroe, *supra* note 398.

400. *See supra* Part III.A (explaining briefly that, in the author's proposal, the government would guarantee loans made to businesses from a lender).

401. *See supra* Part III.A.5 (proposing disclosure requirements for maximum transparency of the loan terms).

reorganization process.[402] Seeking a government guaranty would require the lenders to relinquish that control.[403]

Debtors in possession, likewise, have no incentive either. They already have little cash; they cannot afford to spend any of it lobbying the government.[404] And even if a debtor in possession tried lobbying the government for a guaranty program once the debtor neared or was in bankruptcy, any success would likely take too long to be valuable.[405] By its very nature (and often for good reason), the government often moves at a slow, beuracratic pace—not helpful when the debtor needs a DIP loan as soon as possible.[406]

Could a solvent, healthy business lobby for reform in advance of a potential bankruptcy so that if the business does file for Chapter 11, the reform would already be implemented and the business could maintain control? Doubtful. For one, a healthy business would likely not waste time and resources for something that might eventually benefit it in bankruptcy because healthy businesses have no intentions of going bankrupt. Though it may be prudent to be cognizant of a potential bankruptcy, a business is not likely to consider the possibility until the last minute. In addition, a solvent, healthy business is likely not aware of the problems with DIP loans. It would not know from experience because the business has never been through bankruptcy. And it would not know from information because, again, healthy businesses do not consider the ramifications of bankruptcy until the last minute.[407] Healthy businesses do not employ bankruptcy counsel until it is necessary.

That no one has already implemented this proposal does not refute its merit. This proposal is a low-risk solution to a severe problem that has

---

402. *See supra* Part II.B (discussing why DIP lenders want control and the ways they can control the debtor's business under the current regime).

403. *See supra* notes 364–68 and accompanying text (explaining that government-guaranteed loans would reduce the ability for lenders to use self-serving tactics).

404. A. Mechele Dickerson, *Regulating Bankruptcy: Public Choice, Ideology, & Beyond*, 84 WASH. U. L. REV. 1861, 1879 (2006).

405. *See Congress: the People's Branch?: How a Bill Becomes a Law*, http://www.ushistory.org/gov/6e.asp (last visited Dec. 4, 2018) (highlighting the difficulty in timely passing a bill and the scarcity of passed legislation).

406. *Cf. Section 10. General Rules for Organizing for Legislative Advocacy*, CMTY. TOOL BOX (2018), https://ctb.ku.edu/en/table-of-contents/advocacy/direct-action/legislative-advocacy/main (explaining that advocating for legislative change is a slow process).

407. *See* Natalie Wilson, *Making the Best of a Bad Situation: Planning for Business Bankruptcy*, THELAWTOG, https://thelawtog.com/making-the-best-of-a-bad-situation-planning-for-business-bankruptcy/ (last visited Dec. 4, 2018) (noting that no one plans on filing for bankruptcy when they start a business).

infected the bankruptcy system.[408] And yet, despite being low in risk, guaranteeing DIP loans would generate high political, economic, and social benefits.[409]

CONCLUSION

Anytime you suggest what the government should do with financial resources, you open yourself up to political and economic discourse. Add a bankrupt business to the other side of the equation, and the likelihood of discourse surely grows.

I understand that, at first glance, this Article's thesis appears controversial. It (seemingly) uses taxpayer money for the benefit of large companies, banks, and investment funds. I hope, however, that after the Article's explanation, the reader understands the thesis as a pragmatic and effective solution to a major problem—a dividing contrast between legislative theory and bankruptcy practice.

By guaranteeing loans to debtors in possession, the government would provide flexibility in loan provisions and confidence in loan repayment.[410] In doing so, the government would shift control back to the debtor in possession, just as the Bankruptcy Code prescribes.[411] Debtors in possession would be more able to successfully reorganize and preserve valuable jobs.[412] Lenders would continue to receive a financial return on their loans, with the added safety and protection of a government guaranty.[413] And the government would earn a financial return on the fees it charges while preserving more jobs for society.[414]

If the government implemented a guaranty program, future research could and should be conducted. The potential topics would be plentiful. Scholars could examine how the guaranties changed loan provisions. They

---

408. *See supra* Part III (providing a framework for restoring debtor control of distressed businesses while minimizing risks to taxpayers).

409. *See supra* Part III.B (outlining the potential political, economic, and social benefits of the proposed framework for government guaranteed DIP loans).

410. *Cf.* Norris & Kaneda, *supra* note 300 (explaining how SBA guarantees reduce risk to lenders and thus make them willing to offer more flexible terms).

411. *See* 11 U.S.C § 1107(a) (2012) (declaring that a debtor in possession is to have all the rights and powers of a trustee); *id.* § 1108 (granting trustees the power to operate a debtor's business).

412. *See* CITY BAR JUSTICE CTR., BANKRUPTCY BASICS: A GUIDE FOR EMPLOYEES WHOSE EMPLOYER FILES FOR BANKRUPTCY 3 (2016), https://www.citybarjusticecenter.org/wp-content/uploads/2016/11/Bankruptcy-Basics-A-Guide-for-Employees.pdf (noting that Chapter 11 re-organizations enable businesses to retain and pay employees).

413. *See supra* Part III.A (discussing how the proposed guaranty system would protect DIP lenders).

414. *See supra* notes 389–97 and accompanying text (asserting that the proposed system would increase government net revenue while preserving jobs).

could compare default rates of guaranteed loans with non-guaranteed loans. They could study whether the guaranties have encouraged new lenders to enter the market or whether only current lenders use the guaranties. They could determine the rate at which the government will agree to guarantee a DIP loan and what factors the government appears to consider in its decisions. They could examine if the program is financially successful for the government. The list goes on.

If the federal government successfully implemented this solution, local governments could follow suit by guaranteeing the DIP loans for smaller, local businesses. Or alternatively, local governments could test this solution with their local bankrupt businesses, and then the federal government could follow suit.

Regardless of whether local or federal governments implement the proposed program, such a program would realign bankruptcy theory and practice, generate a financial return for the government, and preserve jobs within the economy. This Article is the first to provide a comprehensive framework for a DIP loan guaranty program. Though its success may not be guaranteed, the program is a low-risk, high-reward solution to a bankruptcy problem that desperately needs solving.