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Abstract

There is an increasing debate on whether creditors exert excessive power and influence through their DIP (Debtor-in-Possession) lending arrangements in the Chapter 11 bankruptcy process. DIP lenders often advance the priority of their prepetition claims as a reward for extending credit (through DIP financing) through roll-up or cross-collateralization provisions. As these provisions violate the general principle of equitable treatment among the same class in bankruptcy, they are viewed as products of excessive creditor control. Hence, the paper compares U.S. bankruptcy cases from 2009 to 2011 with roll-up or cross-collateralization provisions in their DIP arrangements to those without, focusing on the CEO turnover rate and the strictness of covenants as signals of creditor control. As companies with those provisions report higher CEO turnover rates and stricter covenants, it is concluded that DIP agreements with cross-collateralization or roll-up signal greater creditor control than those without.

Keywords

Bankruptcy, Chapter 11, DIP (Debtor-in-Possession) Financing, Creditor Control

**ROLL-UP & CROSS-COLLATERALIZATION IN DIP (DEBTOR-IN-POSSESSION)
FINANCING AS MEASURES OF CREDITOR CONTROL**

By

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An Undergraduate Thesis submitted in partial fulfillment of the requirements for the
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ABSTRACT

There is an increasing debate on whether creditors exert excessive power and influence through their DIP (Debtor-in-Possession) lending arrangements in the Chapter 11 bankruptcy process. DIP lenders often advance the priority of their prepetition claims as a reward for extending credit (through DIP financing) through roll-up or cross-collateralization provisions. As these provisions violate the general principle of equitable treatment among the same class in bankruptcy, they are viewed as products of excessive creditor control. Hence, the paper compares U.S. bankruptcy cases from 2009 to 2011 with roll-up or cross-collateralization provisions in their DIP arrangements to those without, focusing on the CEO turnover rate and the strictness of covenants as signals of creditor control. As companies with those provisions report higher CEO turnover rates and stricter covenants, it is concluded that DIP agreements with cross-collateralization or roll-up signal greater creditor control than those without.

Keywords: Bankruptcy, Chapter 11, DIP (Debtor-in-Possession) Financing, Creditor Control

INTRODUCTION

One of many common reasons why firms file for Chapter 11 is that they are suffering from operational difficulties, along with low liquidity. An important function in Chapter 11 is providing that liquidity during the reorganization process to help the troubled company recover in a timely and efficient manner. The bankruptcy court provides this liquidity through DIP (Debtor-In-Possession) financing. One important thing to note is that because DIP financing is so crucial to the bankrupt firm's recovery, the DIP lender has immense negotiating leverage and usually demands lending arrangements that improve their economic position (often at the expense of other parties). However, recently these lending arrangements have come under more scrutiny as many people interpret them as products of excessive creditor control. Specifically, arrangements such as roll-up and cross-collateralization generate a lot of controversy as they are viewed as abusive practices of massive power and influence DIP lenders have.

Roll-up and cross-collateralization provisions effectively serve the same purpose in that they favor the DIP lender's prepetition claims over claims of other prepetition creditors. A roll-up usually requires that the debtor draw on the DIP loan to pay off some or all of the lender's prepetition claims. The DIP lender arranges DIP financing in a way that effectively pays off its prepetition debt, "rolling up" its prepetition debt. In other words, this essentially refinances the pre-bankruptcy debt with DIP debt, which greatly improves the prospects for repayment of the debt and further enhances the DIP lender's significant influence over the process. A similar concept is cross-collateralization, where the debtor grants a security interest in otherwise unencumbered assets of the company for both prepetition and post-petition claims of the DIP lender. As a reward for extending credit, the DIP lender essentially takes the collateral – the same collateral that would otherwise be distributed among prepetition creditors equitably – and

uses some of it to only improve its prepetition claims. Thus, roll-ups and cross-collateralization are controversial because they create potential conflicts with the general bankruptcy principle of equal treatment among the same class. The fact that Section 364 of the Bankruptcy Code does not expressly authorize these arrangements also doesn't add to their legitimacy.

Therefore, with economic incentives tied to the structure of DIP financing, there is an increasing debate on whether these arrangements are associated with excessive creditor control, who want to “milk” the company and abuse their power to maximize their benefits, not the firm's long term value. Taking this concept as a springboard, I hope to examine this issue further in this paper by analyzing whether cross-collateralization and roll-up provisions are associated with creditor control, with empirical data of bankruptcy cases from 2009-2011.

LITERATURE REVIEW

There are multiple papers that explore the theory behind DIP financing in Chapter 11. Many of them mention potential conflicts of interest between the DIP lender who benefits asymmetrically, other impaired creditors, and the debtor. Although not all of them produce constructive solutions, some develop insightful frameworks that can be used to understand the DIP financing dynamic.

One of the most prominent experts, Triantis (1993), mentions how the desirability of the DIP financing depends on more than whether the return to the lender is competitive. Namely, it mentions that the distinguishment has become blurry between DIP lender's anticipated returns from expected increases in the value of the debtor's assets and the anticipated returns from transfers of wealth from prepetition claimants. Triantis argues that only desirable financing

arrangements that promote optimal investment and asset deployment decisions should be allowed.

It also mentions other factors such as judicial ambiguity when faced with arrangement details of vague importance. Generally, courts leave the conditions regarding DIP financing to the business judgment of the debtor. For example, when courts need to decide whether roll-up or cross-collateralization provisions in DIP financing are necessary, they reserve from making a strong objection since many times DIP financing is so necessary for the firm's successful reorganization. Thus, the paper suggests that courts be aware of possibilities of unfair distribution of debtor's assets, and exercise its discretion to only promote firm value maximizing investment decisions.

Further exploring the potential conflicts of interest in the bankruptcy process, other papers analyze the extent of creditor control. According to Ayotte and Morrison (2007), contrary to common belief at the time, equity holders and managers are shown to have almost no control over the reorganization process. Instead, the paper finds that creditor control is pervasive, demonstrated by several, specific metrics. From a sample of large privately and publicly held businesses that filed Chapter 11 during 2001, 70 percent of CEOs were replaced in the two years before a bankruptcy filing, with some reorganization plans deviating from the absolute priority rule in value distribution. Also, senior lenders were observed to exercise significant control through strict covenants, such as line-item budgets, capital expenditure limits, EBITDA targets, and other financial covenants in DIP financing. Interestingly, although senior secured lenders usually exert significant control, junior creditors also filed objections in more than half of the cases, acting through a creditors' committee. The paper concludes that pervasiveness of creditor

control doesn't eliminate the fundamental inefficiency of the bankruptcy process of resource allocation.

Tung (2017) further examines the relationship between economic conditions and DIP loan terms. He finds that ordinary loan provisions like pricing and reporting covenants are sensitive to economic conditions. However, he also finds that provisions that are often justified as necessary to induce DIP lending, have no statistically meaningful relationship with economic conditions. Specifically, there is no obvious relationship between credit availability and the existence of roll-up. Tighter credit environments signal higher levels of concern, from banks and lenders, of the borrower's ability to pay back due to macro factors. If lenders require stricter covenants or higher economics due to macro factors, it would be less likely due to internal creditor control factors. However, the existence of milestones – covenants that set specific deadlines for achieving important (usually operational) metrics – and roll-ups in DIP lending agreements were not correlated with pessimistic credit markets. Therefore, it might be possible that certain DIP lenders exert excessive control through these provisions, where economic conditions do not necessarily prompt them to do so. He concludes his paper by urging policymakers and judges to question if sweeteners in DIP lending arrangements are really necessary to induce lending.

The general trend of re-thinking these provisions is also present outside of the academia. The American Bankruptcy Institute, a nonpartisan organization that assists congressional committees and legislative staff on issues related to insolvency, also observed the proliferation of these arrangements in DIP lending in its 2014 report of Chapter 11 practices. It sought to resolve differences in opinions regarding “the permissibility of cross-collateralization and roll-up provisions in post-petition financing activities,” acknowledging that there is an opportunity for

“abuse” of these provisions.¹ The Commission made several recommendations, including that extraordinary provisions such as roll-ups and cross-collateralization not be permitted in interim orders. Also, it recommended approving roll-ups only if the new money from the DIP loan comfortably exceeds the size of the roll-up, and the DIP loan at issue is the best available option and is in the best interests of the estate.

Many researchers, along with ABI, have explored the extent of creditor control, and the idea and the dynamics of DIP lending, but no one has explicitly analyzed the extent of creditor control measured through these provisions such as cross-collateralization or roll-up. Taking the insight from Tung, that roll-ups are not correlated with economic conditions, as a springboard, I intend to further analyze whether roll-ups and cross-collateralization are also directly associated with greater levels of creditor control.

HYPOTHESIS

With such controversy over roll-up and cross-collateralization provisions, Tung has shown that roll-ups are not related to economic terms. However, there still remains a question if these provisions are products of excessive creditor control that lead to creditors having exorbitant influence over the reorganization process, possibly hampering a more successful and fair one. The act of improving the recovery of prepetition claims as an exchange for extending credit into the bankruptcy can be seen as a signal that DIP lenders believe in the firm’s optimistic future or that they are more invested in the firm’s outcome for whatever other reasons. In either case, since their economic profits are directly affected by the firm’s performance, DIP lenders are incentivized to desire greater control of the reorganization process. Thus, my hypothesis is that

¹American Bankruptcy Institute. “*Commission to Study the Reform of Chapter 11.*” ISBN: 978-1-937651-84-8. 2014, 77.

DIP agreements with cross-collateralization or roll-up signal greater creditor control than those without. Consequently, my alternative hypothesis is that there is no relationship between these provisions and creditor control. It might be the case that cross-collateralization and roll-up provisions are not associated with control, but some other motivation. Perhaps, if DIP lenders really wanted control, they would have exerted it through other tools such as higher interest rates in lending terms rather than through roll-ups or cross-collateralization.

After detailed analysis, I hope to find a definitive correlation between these provisions and creditor control. But if there is none, further research would be recommended to assess and single out other sources of motivation for the provisions.

METHODOLOGY

To measure how much creditor control these provisions signal, it is crucial to define specific metrics. I plan to use two measurements of creditor control: (i) CEO turnover or new CRO (Chief Restructuring Officer) appointed within the two years prior to filing, and (ii) existence and strictness of milestones and covenants. First, CEO turnover or a new CRO usually signals that creditors were so unhappy with the firm's financial situation that it took extreme action to replace a key operational member, exerting control over the firm.

Second, milestones or strict covenants in the DIP lending limit the debtor's daily operational activities. As creditors decide on metrics such as budget limits, EBITDA targets, restrictions on proceeds from sales, and various financial covenants when lending, debtor has to comply with these terms to access financing. As creditors have immense power to curb certain actions and prevent potential managerial behavior that might hurt creditors' interests, the existence of covenants and milestones is another strong signal.

The dataset comprises of public company bankruptcy cases from January 2009 to December 2011, monitored and organized by U.S. Securities and Exchange Commission (SEC), available on their website. For comparability reasons, I intend to only include cases with DIP lending from a prepetition lender. Then, I will split the data into two parts: those with cross-collateralization and roll-up, and those without. For practical reasons, I will focus on companies with asset sizes of at least \$100 million and at most \$10 billion, with priorities given to cases from Southern District of New York (SDNY) and Delaware courts. Small companies are excluded due to potential lack of significance, while large companies might have too many confounding factors to single out the effect of roll-up and cross-collateralization. SDNY and Delaware courts are given priority since they are well known for their experience and expertise with corporate bankruptcy cases. Since most bankruptcy cases of prominence have historically filed with these courts, it would be useful to analyze cases from these courts to examine general trends as well.

Available databases include SEC Edgar, Bloomberg, and Public Access to Court Electronic Records (PACER). SEC Edgar keeps all public filings of U.S. listed companies. Among these, 8-Ks, DIP financing disclosure documents, and credit documents are useful in obtaining information on specific DIP financing terms and inter-creditor agreements. Bloomberg is used for findings news articles about CEO or CRO of bankrupt companies, while PACER has court dockets that outline various stages of the reorganization process.

For the first part of results, I intend to simply lay out exploratory findings, similar to how it was done by Tung in his most recent paper. By examining factors such as the frequency of DIP financing from a prepetition lender out of all DIP lenders, how often cross-collateralization and

roll-up occur, the average size of claims in the dataset, and the distribution of cases among various states, I plan to paint a broader picture at first just to describe some general trends.

For the second part of results, I intend to analyze the association between the existence of cross-collateralization or roll-up in DIP financing and two aforementioned measures of creditor control. The first measure of the removal of CEO or the appointment of CRO is a binary factor, and thus is straightforward. For example, I will seek to find out if there is a significant difference between the CEO removal rate from DIP lending with the provisions and the CEO removal rate from DIP lending without. For most statistical analysis work, I will be using the statistical software R and Microsoft Excel. If the statistical test reveals that there is a meaningful difference, then the conclusion would be that these provisions signal greater creditor control.

The third part of the results will involve discussion of covenants and milestones. However, covenants and milestones are more complex because they have different levels of severity and strictness, which imply different levels of creditor control. Thus, I plan to first understand what covenants or milestones exist specific to DIP lending arrangements. Then, I intend to explain their severity in the context of Chapter 11, reflecting on its connection to excessive creditor control in the bankruptcy process.

RESULTS

Exploratory Data Analysis

To make the analysis more meaningful, the dataset used for the purpose of this paper was modified from the original dataset, which is the list of all public company bankruptcy cases from January 2009 to December 2011, available on the SEC website. Excluding companies with asset sizes of \$100 million or smaller, and \$10 billion or bigger due to aforementioned reasons, the

number of available companies for analysis was 107. Then, certain companies were excluded due to the lack of data from public sources, entries with missing or incorrect liabilities sizes, and duplicate entries. After the process, the new dataset had 70 entries.

From the new dataset, the distribution of the company's size (based on the size of the assets) is illustrated below in graph 1. The distribution is skewed to the right, as mean is 876 and median is 500 (in millions of U.S. dollar). This explains that based on the availability of the data, there were many smaller companies around the size of \$100-500 million than companies bigger than \$1 billion.

Graph 1: Distribution of Companies by Asset Size

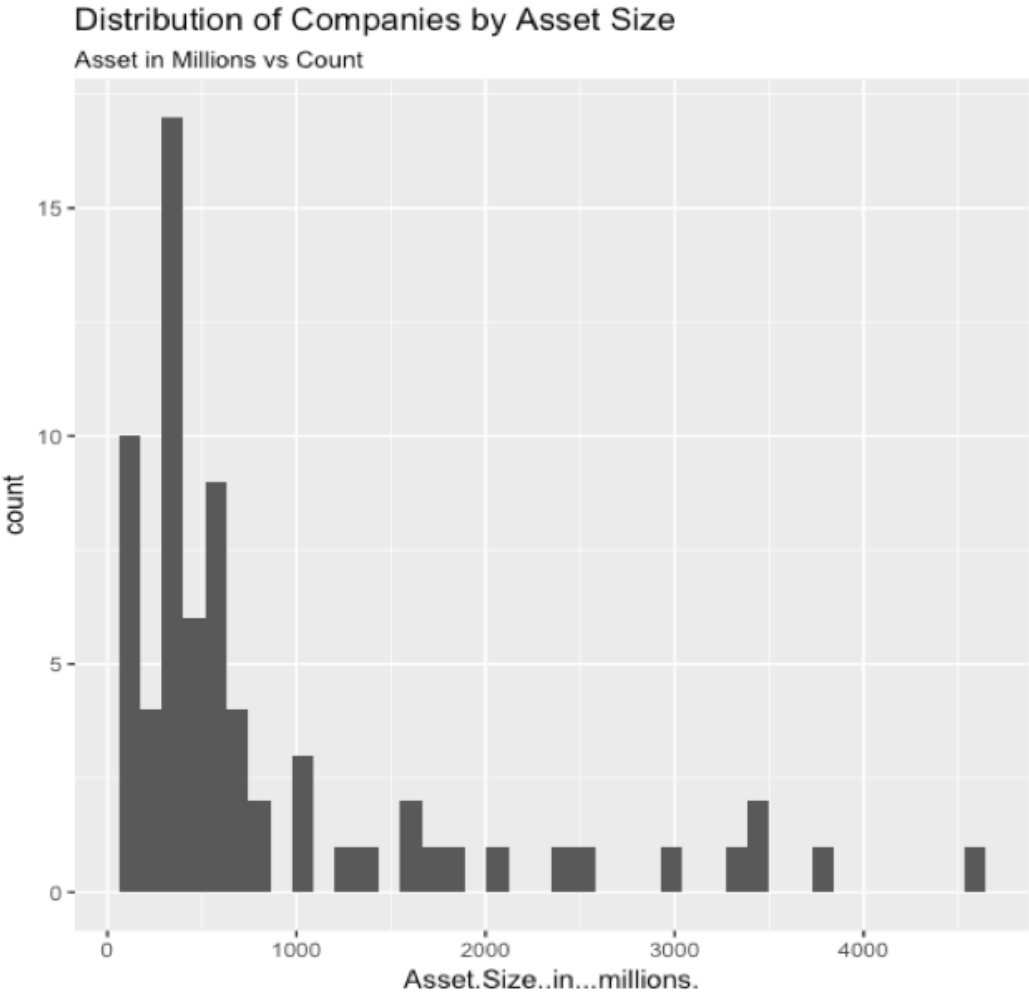
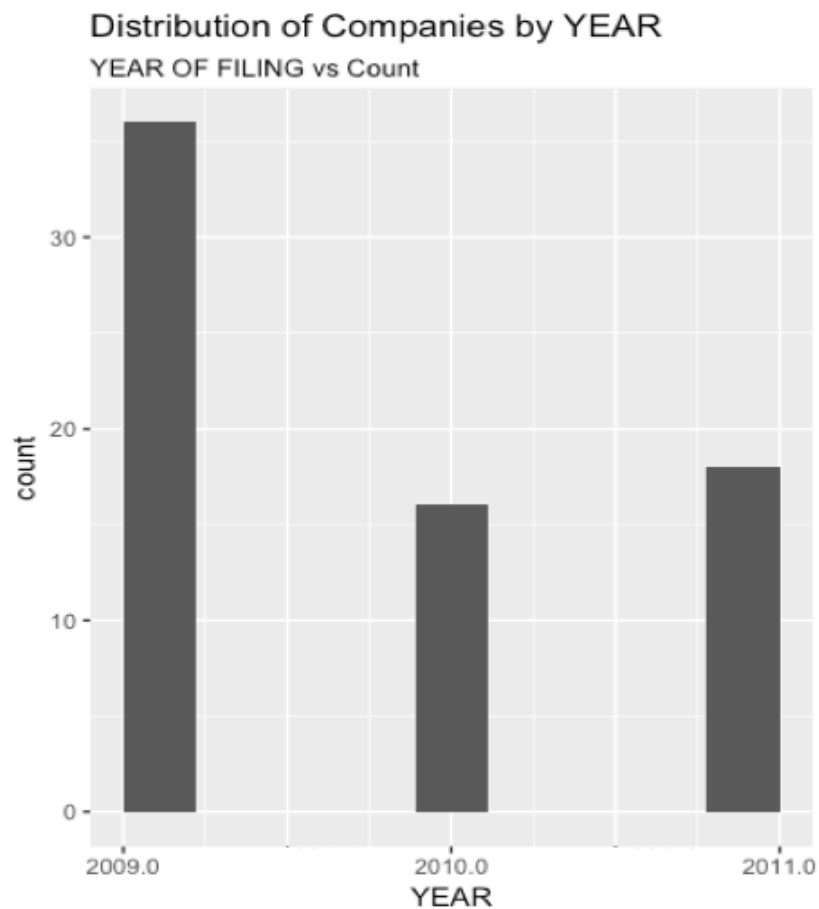


Table 1: Summary Statistics of Asset Size Distribution

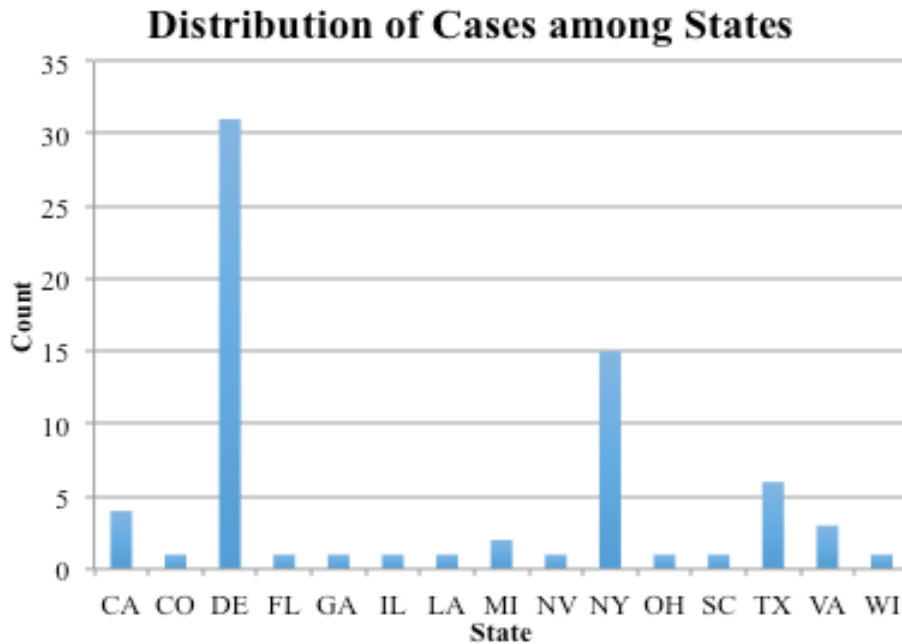
Asset Size (in \$ millions)	
Mean	876
Median	500
Entry	70

Also, as illustrated in graph 2, the distribution of bankruptcy cases between 2009-2011 is more focused in 2009. Since the financial crisis happened in 2007-2008, many companies probably went into bankruptcy during and shortly after the crisis. Thus, there are many more companies filing for bankruptcy in 2009, decreasing by almost half in 2010, and increasing a little in 2011.

Graph 2: Distribution of Companies by Year



Graph 3: Distribution of Cases among States



As illustrated by graph 3, Delaware and New York have the most number of cases, followed by Texas, and California. As many companies are either headquartered in Delaware or seek for bankruptcy relief in well-experienced, arguably debtor-friendly courts such as Southern District of New York and Delaware, these two states seem to be the most popular states to file in. Texas was the third popular state to file, potentially because of the prevalence of energy companies in the state. California was the fourth popular, probably because it is a big state with many companies.

Table 2: Breakdown of All Companies

Breakdown of All Companies		
	Count	Percent
Liquidated	15	21%
DIP Financing	45	64%
No DIP Financing	10	14%
Total	70	100%

Based on table 2, out of the 70 entries, 15 companies liquidated (about 21 percent) and 45 companies (about 64 percent) received DIP lending. It seems that the existence of DIP lending was more common as the company size grew, because many small companies ended up in liquidation. It's possible that these companies were judged to be worth too small to go through the restructuring process or to not have a viable business plan going forward.

Table 3: Breakdown of Companies with DIP from Prepetition Lender

Breakdown of Companies with DIP from Prepetition Lender		
	Count	Percent
Roll-up	29	78%
Cross-collateralization	27	73%
Either of two	34	92%
Total	37	100%

Out of the 45 companies that received DIP lending, 37 (about 82 percent) had DIP lenders that had prepetition claims in the company. Then, as shown in table 4, out of those 37 companies, 29 companies had either partial or full roll-up provisions in their DIP lending agreements. Similarly, out of the same 37 companies, 27 had cross-collateralization provisions in their DIP lending agreements. Considering cross-collateralization and roll-up provisions both serve the same purpose in that they advance the interests of DIP lenders' prepetition claims possibly at the expense of other prepetition lenders, 22 companies had both provisions. Therefore, without the overlap, 34 out of the 37 companies had either some type of roll-up or cross-collateralization provisions. In other words, an impressive 92 percent of companies who had DIP lenders that were also prepetition lenders sought to advance their prepetition claims through roll-up or cross-collateralization. From this observation, it can be concluded that most, if not all, of the DIP lenders are greatly concerned about the recovery of their prepetition lenders and that they don't hesitate to extend DIP lending with the two provisions to sweeten the deal.

Statistical Analysis

To find out if there is a meaningful relationship between CEO turnover and roll-up & cross-collateralization in DIP lending agreements, correlation between CEO turnover and either roll-up or cross-collateralization is examined.

Table 4: Correlation between Variables

Pearson Correlations	
Roll-up ~ CEO Turnover	0.189
Cross Collateral ~ CEO Turnover	0.189
Asset Size ~ CEO Turnover	-0.082
Asset Size ~ Cross Collateral	0.294
Asset Size ~ Roll-Up	-0.112

Based on table 4, the correlation between roll-up and CEO turnover as well as the correlation cross-collateralization and CEO turnover are both pretty low at 0.189. Although the correlation is positive, it seems that the number is not very high. Also, the correlation between asset size and CEO turnover is negative at -0.082. This implies CEOs of bigger companies are slightly less likely to be removed, although the difference is very small. Perhaps DIP lenders even decide that if their troubled company is big and complicated, having established and existing leadership in place may work better than trying to shake up the whole company with a brand new management team.

Table 5: CEO Turnover Rate in Different Cases

CEO Turnover Rate	
With Roll-up	Without Roll-up
78%	57%
With Cross-Collateralization	Without Cross-Collateralization
74%	43%

In addition, there seems to be a difference between the CEO turnover rates, depending on whether the debtor had a roll-up/cross-collateralization or not. Based on table 5, the CEO

turnover rate was higher at 78 percent for companies with roll-up than those without at 57 percent. Also, the rate was higher at 74 percent with cross-collateralization than at 43 percent without. CEO turnover happens much more frequently when there are cross-collateralization or roll-up provisions. Also, the CEO turnover rate with roll-up (78 percent) was 4 percent higher than the turnover rate with cross-collateralization (74 percent). Similarly, the turnover rate without roll-up (57 percent) was 14 percent higher than the rate without cross-collateralization (43 percent).

Analysis on Covenants and Milestones

Since covenants are extremely individualized and complex depending on the context, it was difficult to quantify any particular measure. However, there were some notable findings. Some types of covenants were more commonly seen in DIP lending agreements with cross-collateralization and roll-up provisions than those without. For example, it was common to see stricter rules laid out for the use of DIP proceeds. More specifically, the use of DIP had to be made with the expenditure line items set forth on a budget that the company presented to the lenders, which are limited to, payment of transactional fees, costs, and expenses incurred in connection with the DIP lending agreement.

Also, several milestones were frequently mentioned. Specifically, the filing, solicitation, and approval of a plan of reorganization and approval of the related disclosure statement by a certain date were common. Among the more stringent ones was achieving a certain financial metric, such as EBITDA or revenue, or the completion of a specified sale of the debtor's assets by a certain date. The last one was especially prominent in a case where the DIP lender, upon the violation of a milestone covenant, gained significant control of the company and sold all of the

debtor's assets. Thus, although it was tough to compare all covenants side-by-side in all companies, it appears that companies with cross-collateralization or roll-up provisions had more stringent covenants, sometimes deliberately unrealistic milestones, than the companies without.

DISCUSSION

My hypothesis was that having roll-up or cross-collateralization provisions in DIP lending arrangements signal greater creditor through having i) higher CEO turnover rates, and (ii) more strict covenants. First, it is clear that companies with either of the two provisions have higher CEO turnover rates. In general, more than 70 percent of companies with either roll-up or cross-collateralization appointed a new CEO. Thus, those two provisions can be a way to signal greater creditor control, at least exerted through the changing of CEOs. Also, although the difference is small, companies with roll-up recorded a higher rate of CEO turnover than those with cross-collateralization, which implies that roll-up is a slightly stronger signal than cross-collateralization. The correlation between CEO turnover and both cross-collateralization and roll-up was both 0.189, a small positive number. Although it is small, the positive correlation shows that existence of cross-collateralization and roll-up is still associated with CEO turnover.

Second, although covenants were difficult to standardize across a variety of companies, the findings showed existence of stricter covenants, especially of demanding milestones in an extreme time pressure, in DIP lending agreements with roll-up or cross-collateralization. Satisfying objectives such as getting a court approval of the reorganization plan, which is dependent on the court and not solely under the debtor's control, in a short period of time, like within 30 days, is very tough if not infeasible in some cases. Moreover, budgeting line-items such as EBITDA, revenue, and capital expenditure are severely limiting to the debtor, increasing

the amount of influence DIP lenders have in the restructuring process. Thus, greater creditor control is also manifested through more stringent covenants and milestones when DIP arrangements have cross-collateralization and roll-up provisions.

Finally, there are some interesting observations that do not necessarily fit the scope of the hypothesis but give information on how certain bankruptcy cases with DIP financing proceed. Specifically, there were notable cases among the dataset where chapter 11 ended in a 363 sale, liquidation, or a buyout by the DIP lender who was also a prepetition lender. These cases were common where the lender imposed impractical milestones so that when the debtor couldn't comply with them and was in technical default, the lender could seize the company and either sell it in a 363 sale or buy it out at a cheap price. Therefore, these proceedings could be expressed as other ways to exert control over the debtor.

Overall, based on the results from the dataset used, it appears that lenders with roll-up or cross-collateralization clauses in their DIP lending agreement signal greater creditor control of the debtor by having a higher CEO turnover rate and imposing more demanding covenants.

LIMITATIONS

Several limitations to this research paper exist. First and foremost was the lack of information in the construction of the overall dataset. Only using information available through public resources and databases, finding detailed data on terms of DIP lending agreement or covenants, and even sometimes the CEO turnover was a difficult and time-consuming task. Smaller, more regional companies also do not have extensive coverage and thus are more challenging to find data on. Therefore, it should be noted that the paper only considers readily

available public information and does not take into consideration private data that might have more insights.

Second, the dataset may have been too small with some noise. The number of companies that received DIP lending from prepetition lenders was 37. When dividing those 37 companies into with roll-up or without roll-up and with cross-collateralization or without cross-collateralization, the dataset size in each category decreased even more. This might have introduced some noise during the analysis of correlation and CEO turnover rates.

Third, the dataset is also limited in timeframe between 2009 and 2011. This is important to address since the credit market then was extremely tight. Thus, creditors during that time might have wanted more control and wanted to secure every measure of protection possible for their claims. This would have introduced a bias in the findings if the creditor behavior during 2009 to 2011 were not a true reflection of the general creditor behavior among all Chapter 11 bankruptcy processes. However, although this might be true, creditors in any bankruptcy process would want to have as much protection as they can. Therefore, limiting the timeframe to 2009-2011 might have magnified creditor concern, but probably not changed the entire direction of the fact that creditors would have wanted more control of the debtors when extending DIP financing.

CONCLUSION

Overall, there still remain many questions on making sure that Chapter 11 process runs fairly and efficiently, while maximizing economic benefits of associated parties and the future value of the firm. While cooperation of all stakeholders is necessary throughout the process, excessive creditor control, especially when it comes at the expense of others and hampers a more successful reorganization, should not happen. While it is extremely difficult to clearly distinguish

the extent to which cross-collateralization or roll-up provisions are products of excessive creditor control or simply necessary tactics to induce creditors to extend credit, it seems that the case for excessive creditor control stands strong based on the findings of this paper. Bankruptcy professionals, as well as interested scholars in this topic would benefit from knowing the potential for excessive creditor control in bankruptcies with DIP financing. However, the findings from the paper are in no way final or definite. Therefore, given the limitations regarding the dataset in this paper, conducting more thorough research on similar issues with a bigger dataset would provide additional conviction, perhaps with the inclusion of more recent bankruptcies for current trends.

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