Statement of
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HAS THE "FRESH START" GONE STALE?

Ideally, commencing a chapter 11 case should be just another item on the list of corporate actions available to a company, similar to doing a rights offering or a financing. Companies in distress have never quite gotten to that level of comfort, because of a long held belief in the market that filing equals insolvency and that therefore a stigma should be attached to chapter 11. But because of how the chapter 11 process has evolved, with creditors doing their best to strip debtors of control ever earlier in the case and the debtor's idea of how to reorganize becoming ever less relevant, "fear of filing" would seem to be more prevalent- and maybe more justifiable - than ever.

As several of the members of this Commission noted in their statements at the inaugural public hearings on April 19, 2012, chapter 11 reorganization was intended to provide essentially viable businesses burdened with too much debt with a "fresh start." While the Bankruptcy Code contains a number of provisions that protect creditors' interests, encourage compromise, and ensure that the debtor's reorganization is not accomplished by running roughshod over creditors'

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rights, the presumption was that existing ownership and management would remain in place, would continue to operate the estate's business, and would have the time and flexibility to propose and implement its own plan of reorganization.

Thus the Code contained – and still contains -- a number of provisions that give debtors leverage. The debtor may use cash that is pledged to a creditor, so long as it obtains a court order finding that the debtor is providing "adequate protection" of the creditor's interests. The debtor, and the debtor alone, decides whether it wants to sell assets. The debtor makes its own determination about how favorable or unfavorable its contractual relations are and whether it wants to keep them. The priority for administrative expenses ensures that the cost of postpetition operations, including the compensation due to the employees who kept the ship afloat, must be paid in cash and kept current. The debtor's exclusive period to propose and solicit a plan gave debtors the ability to make their case to the judge that they should be allowed to keep control of the case, for an indefinite period. Finally, when it came time to propose a plan of reorganization, debtors had the powerful tool of cramdown available to them, and the Code provides clear and flexible alternatives for the treatment of secured and unsecured claims.

As a result of some of the amendments to the Code since its enactment in 1978, and of changes in the worldview and the behavior of certain types of creditors, the trend is now skewing toward turning chapter 11 into an ever-more-efficient system for transferring value to creditors, making the "fresh start" of a true reorganization somewhat of a rare result -- and effectively eliminating the option of cramming down secured creditors.

As passed in 1978, the Code did an admirable job of balancing leverage as between the debtor and its creditors. In the climate of the time, compromise flourished – debtors typically had at least some unencumbered cash, secured creditors had extended credit themselves (as opposed to buying debt at a discount), and the clams trading industry was virtually nonexistent. It was relatively easy to reach a deal in most cases because neither side had too much leverage.

Times have changed dramatically. The evolution of the distressed debt market combined with the generally creditor-friendly changes wrought by BAPCPA has created much more leverage for financial creditors. This is apparent in virtually all aspects of chapter 11 cases, from the initial financing, through the period during which the debtor is operating in chapter 11, and finally to the plan of reorganization process itself.

It all starts, and the debtor's prospects for a fresh start often end, with the DIP financing. These days, if a debtor needs postpetition ("DIP") financing, it's very likely to have to give up control over its destiny to the DIP lender. And debtors almost always do need DIP financing. First of all, it is the rare company that by the time it has to file chapter 11 has not granted liens on all or substantially all of its assets, usually in an attempt to avoid having to file. The phenomenon of "extend and pretend" has been well-documented, but it is worth noting that the extensions usually have a cost attached, not only in dollars but in granting new liens and new collateral, such that all of a debtor's assets are very likely to be "liened up" (often with multiple levels of debt) by the time it files.

Second, it's expensive to have "debtor-in-possession" attached to your name these days. The recent addition of Section 503(b)(9)'s protection for suppliers of goods in the days before filing has created a new protected class of creditors who must be paid in full, in cash, unless they agree otherwise, and bankruptcy judges are ensuring that they are protected. And then there are the professional fees and the number of professionals retained in many cases. Claims agents have become de rigueur in even middle market cases (mandatory in some districts in cases with more than a designated number of creditors), and their fees must be paid. In addition, the United States Trustee will often take positions with respect to conflicts of interest that necessitate the retention of multiple professionals for the debtor. If more than one committee is appointed, the need to hire counsel and financial advisors for each of them adds to the cost as well.

When the debtor, who as we have just seen is very likely to need money, starts looking around for lenders, it's not likely to find a robust market. The obvious choice is existing lenders, who have the advantage of being very difficult to prime, so they have a good chance of getting their way. When the debtor shops the loan, as it is required to do, it is likely to meet resistance from potential lenders who may feel (correctly) that they are being used to get a better deal from the existing lender. As a result, potential alternative DIP lenders almost always require a hefty (and nonrefundable) "work fee" before they will provide a term sheet.

Regardless of where the debtor gets its DIP financing, the game has dramatically changed. Lenders providing postpetition financing no longer do so in order to make good returns with assured repayment, or protect their prepetition positions by getting collateral for previously unsecured loans. Instead, they often do so in order to 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. Examples include: DIP financing matures, and no further funds may be lent, unless the debtor holds a sale of its assets under Section 363 of the Bankruptcy Code within 60 days after the date of the funding; any pleadings filed in the case must be preapproved by the DIP lender; the debtor cannot file a plan without preapproval by the DIP lender, etc. The sanction, of course, for violation of any of these conditions is that the debtor will be stripped of its financing.

The consequences of this now-routine type of DIP financing are both obvious and drastic. Without first getting DIP lender consent, the debtor cannot do anything outside the ordinary course of business. For example, the debtor is no longer free to seek to assume or reject contracts. It cannot propose an incentive plan to retain critical management players. It cannot sell or decline to sell its assets. But most important, it cannot propose its own plan without lender approval, and it cannot obtain approval of the plan over the opposition of the DIP lender -- or that of any other creditor to whom the DIP lender extends its protection.

The traditional dynamic when the DIP lender presents the debtor with a proposal of this type is that the debtor has no leverage to negotiate because it needs the money and probably can't prime the existing lender. Debtors typically turn to the creditors' committee, which may try to get better terms. The problem for debtors in this situation is that the court cannot require the lender to fund -- so the lender will say that the terms in the draft agreement are its bottom line and if they aren't approved, the lender won't enter into the agreement. Left with no choice, most debtors conclude that they must agree to the conditions of the DIP, no matter how onerous.

When the problem of overreaching DIP financing first arose (though the provisions courts found problematic were tame in comparison with what lenders routinely insist upon today), many districts adopted guidelines stating that certain provisions were disfavored and would be approved only in unusual circumstances. These guidelines have proven largely ineffective, as "special circumstances" apparently include the lenders' unwillingness to lend except on the terms they propose.

This would not be such a problem if most debtors had access to unencumbered cash or unsecured financing, as others who have testified to this Commission have indicated was the case when the Code was enacted. Yet this is no longer the case. Due to a confluence of factors, including the acceptability of the "all personal property of the Debtor" financing statement, which largely eliminates the need for diligence as to the borrower's assets, relatively easy access to credit, and most of all banks' willingness -- and at times eagerness -- to enter into successive amendments and extensions, even though the borrower is clearly in distress, by the time most companies arrive at the point where filing chapter 11 is really the only alternative, they are deep in secured debt.

It is possible to avoid having to obtain DIP financing even when there is significant secured debt, if the business generates enough cash to operate. Before distressed debt trading became prevalent, secured lenders (generally banks) were often willing to allow the use of cash collateral, once certain protections, such as a budget and replacement liens to adequately protect the lender, were implemented.

Now, however, lenders are more aware of the many benefits of being the DIP lender and therefore are unwilling to allow the use of cash collateral alone. Even if the debt is still held by a traditional lender who actually advanced 100 cents on the dollar, the lender is likely to insist on making funds available as postpetition financing, and to go as far as possible to ensure control of the case as a secured creditor. For an existing lender, the protection insisted upon may well include a "rollup" whereby the entire prepetition debt is paid off by the first advance under the DIP, which has the effect of converting prepetition debt to a secured postpetition obligation that cannot be crammed down and must be paid in cash, in full, before the borrower can exit chapter 11.

It would seem beyond dispute that monies that a debtor really needs to operate its business postpetition should be entitled to the highest priority and repayment of these amounts should be assured by whatever means possible. But allowing postpetition borrowing was meant to facilitate the debtor's fresh start, not eliminate the debtor's flexibility to do what it concludes it ought to, taking into consideration but ultimately independent of the DIP lenders' agenda.

At some point the debtor's fiduciary obligations are invoked. To take an extreme example (albeit one that has actually happened), assume that the debtor only truly needs $5mm of postpetition funding. If the Debtor agrees to roll up $50mm of prepetition debt in order to get the $5mm it needs, in at least some situations the transaction harms junior secured and unsecured creditors in an amount far beyond what is needed to operate postpetition.

Similarly, covenants that essentially turn the debtor's discretion as to employee compensation, executory contract assumption and rejection, litigation strategy, and plan formulation over to DIP lender should be viewed as what they are, which is transferring an enormous amount of discretion from the debtor, which has a fiduciary duty to all constituents, to a DIP lender or lenders, which do not.

I would urge the Commission to consider recommending that Congress implement statutory limitations on what a DIP lender may require, or, failing that, at least prohibiting roll ups of prepetition debt.