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Early-Case Orders that Dictate the End-of-Case Orders: Efficient or Disenfranchising?

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AN INSIDER'S THOUGHTS ON FINANCING MOTIONS

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Thoughts expressed here have frequently been the subject of discussion among bankruptcy judges, and are believed to likewise represent the views of most of them. But nothing here should be regarded as necessarily representing the view or future ruling of any other bankruptcy judge.

When bankruptcy judges consider financing motions—for interim (and, later, final) approval of DIP financing, for conditional authorization to use cash collateral,[2] or both—they must depart from their customary norms. When the now-superseded Bankruptcy Act was replaced by the modern Code, it was stated, early and often, that bankruptcy judges would no longer act as case administrators, and instead would spend their time *deciding disputes*.[3] That's still the norm, and the goal. But bankruptcy judges can't always stay true to that norm, since when financing motions are heard early in chapter 11 cases—large or small—bankruptcy judges can't rely on competing interests making their views known.

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[2] You may recall that under section 363(c)(2)(A) and (B) of the Code, a bankruptcy court's authorization for the use of cash collateral is required if, but only if, a secured lender's consent to the use of its cash collateral hasn't been obtained. But in more than 15 years on the bench, and 30 years of practice before that, I never encountered a use of cash collateral without a court order.

That's so, in my view, for three reasons. First (and most significantly), when secured lenders are properly represented, they'll customarily provide only a *conditional* consent—consenting only on condition that they have the benefit of an order giving them, most significantly, adequate protection; limits on the purposes for which cash collateral can be employed; a budget placing monetary limits on the expenditures for which the consent has been granted; or some combination of those things. Second, providing the necessary adequate protection (and, less commonly, other safeguards) typically requires a court order, as it does for substitute liens. Third, the unauthorized use of cash collateral is a serious matter, and in some districts draconian consequences result from it. Securing an order provides a debtor comfort that the use of the cash collateral has been duly authorized, and will not thereafter be questioned.

Thus the conditional consent secured creditors provide is customarily confirmed by—and implemented through—a judicial order. And because the secured lender's shopping list of the conditions imposed for that particular lender's consent can adversely impact other creditors, the bankruptcy court (assisted, when possible, by the US Trustee Program) will need to review the conditions set forth in the proposed order so that the court can assure itself that the conditions are appropriate and not overreaching. Also, when the use of cash collateral is wholly nonconsensual (a relatively rare occurrence), the bankruptcy judge must consider other things as well, for the protection of the lender whose collateral is to be used.

[3] *See. e.g.,* Paul N. Silverstein & Harold Jones, *The Evolving Role of Bankruptcy Judges Under the Bankruptcy Code*, 51 BROOK. L. REV. 555, 569 (1985) ("Under the Bankruptcy Code, bankruptcy judges have been relieved of their former roles under the Act as administrators or supervisors of the debtor's estate and, to a great extent, are confined to the adjudicative function of resolving disputes arising in an adversarial context.") (citing H.R.Rep. No. 595, 95th Cong., 1st Sess. 220, reprinted in 1978 U.S.Code Cong. & Ad. News 5963, 6050-53, 6056-61, 6068-70) (page citations to 1978 U.S.Code Cong. & Ad. News).

In all but the rarest cases, when financing motions are considered on the first day or two of a chapter 11 case (and bankruptcy judges, at least experienced ones, will *always* hear financing motions on the first day or two of the chapter 11 case, if required, as they fully understand the need for immediate action), no creditors committee has been appointed; the debtor lacks the bargaining power to protect the estate against secured creditor overreaching that could prejudice junior secured and unsecured creditors; and those more junior creditors (especially unsecured ones) will have received minimal notice of the matters to be addressed by the court, with limited ability to hire counsel and even less ability for their counsel to get up to speed on the matters to be addressed—or, of course, to change things.

Thus bankruptcy judges—with the help of the U.S. Trustee Program, to whom bankruptcy judges look to fill the gap—lacking the ability to rely on bargaining power parity and an adversarial process to avoid damage to the cases on their watch, take a more active role. Even without objections from other creditors, bankruptcy judges tend to be proactive in satisfying themselves that the debtors have exercised satisfactory business judgment, and—way beyond that—that the proposed financing terms are in the *best interests of the estate*, and do not include provisions that are overreaching or otherwise offensive.

Importantly, practitioners should never expect to succeed on financing motions by resort to the mantra of "business judgment" alone, without further attention to matters of judicial concern in this area, discussed above and below.

A. The Bankruptcy Judge's Mindset

The bankruptcy judge will be approaching First Day Motions generally, and particularly early financing motions, like doctors are taught to approach the practice of

medicine: "Do No Harm." Though that maxim is applicable in many other bankruptcy contexts as well, that principle in the financing motions context cautions the bankruptcy judge to do no harm to the estate or its creditors by authorizing too much, or too little (or, of course, by failing to act at all) at the outset of the case. In the financing motion context, "doing no harm" means doing everything possible to permit the debtor to obtain the liquidity it needs to survive. But "doing no harm" also requires the bankruptcy judge to say "no," from time to time, to overreaching secured creditor requests, to minimize the extent to which junior secured and unsecured creditors are prejudiced—and to avoid (or at least minimize) scenarios under which the estate's value maximizing options going forward are foreclosed.

Financing motions present challenges to bankruptcy judges; they raise the specter of every bankruptcy judge's worst nightmare. As you would expect, bankruptcy judges dread the idea of a debtor's death on their watch, whether by reason of judicial action or inaction, or, for that matter, creditor intransigence. No judge wants a repeat of the infamous *American Remanufacturers* episode,[4] in which the inability of first and second lien lenders to agree on priming lien relief made approval of the DIP financing impossible—resulting in a motion, that had to be granted, for immediate conversion of the case to chapter 7 on the tenth day of the case. And a refusal to approve a motion for DIP financing, or for the use of cash collateral, can have that same effect.

But because the relief granted to secured lenders on financing motions has so much potential to prejudice junior secured and unsecured creditors, and because decisions

[4] *In re American Remanufacturers Inc.,* No. 05-20022 (Bankr. D. Del). Discussion of it can be found on the ABI website, www.abi.org.. For further analysis of the *American Remanufacturers* bankruptcy, see Mark Berman & Jo Ann J. Brighton, *Second Lien Financings Part II: Anecdotes and Speculation—the Good, the Bad and the Ugly,* 25-MAR Am. Bankr. Inst. J. 24 (2006).

made early in the case can dictate the entirety of the case going forward, bankruptcy judges review financing motions, and proposed financing motion orders, with considerable care. Yet bankruptcy judges approach those tasks with several disadvantages. Wholly apart from an impaired adversarial system, they have to digest massive—and prolix—submissions, drafted with little regard for the judges' need to master them in a matter of hours on the first day of the case. And practitioners have historically done little to make bankruptcy judges' tasks easier.

To deal with this problem—or more precisely, to *try* to deal with it—in 1998, now-retired (but still revered) Bankruptcy Judge Peter Walsh, of the District of Delaware, sent a now famous letter to the bankruptcy bar laying out quite reasonable (but nevertheless essential) requirements on the presentation of financing motions, to permit satisfactory judicial review.[5] That letter was the precursor to guidelines enacted in the Southern District of New York in 2002 (and, thereafter, Local Court Rules, in the Southern District of New York, the Southern District of Ohio, the Eastern District of Kentucky, and many other districts across the country), requiring particularized disclosure of "hot button" provisions that would be of particular concern to any reviewing court.

Unfortunately, practitioners were (and still are) so verbose in presenting deal provisions in their financing motions that the "hot button" provisions remained camouflaged, and the motion papers took as long to read as they always did—wholly frustrating the requirements that had been judicially imposed. One of the teachings of this essay, discussed below, is a return to practices required by Judge Walsh and the other

[5] A copy of Judge Walsh's letter is included in these materials.

courts that followed Judge Walsh's lead in making financing motion presentations less prolix and more transparent.[6]

Then it should be noted that for lack of practical alternatives, bankruptcy judges approach financing motions relying principally on their judicial experience, with only modest caselaw guidance upon which to draw. By necessity, the emergency nature of financing motions requires quick (if not immediate) rulings, delivered orally, without the luxury of writing for the future. That gives the bench and bar very little to work with in the next case to come down the road. But that isn't to say that there's no useful guidance at all. Filling a significant gap in this regard is now-retired Jerry Venters' significant opinion in *Farmland Industries.*[7] There, in the context of a motion for approval of a *modified* DIP financing agreement, where he had the luxury of writing to explain his reasoning, he laid out factors which captured, extraordinary well in my view, the mindset of many bankruptcy judges when reviewing financing motions, or at least mine.[8]

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[6] At least my court has required financing motions to be vetted with the U.S. Trustee Program before presentation to the court whenever possible. That procedure doesn't give the U.S. Trustee Program a veto with respect to any particular provision, but facilitates bringing matters of potential concern to the attention of the court, and permits at least some of such matters to be corrected without judicial intervention.

[7] *In re Farmland Industries, Inc.,* 294 B.R 855 (Bankr. W.D. Mo. 2003).

[8] *See id. at* 879-881. He started with caselaw addressing *initial* DIP financing requests (relying in part on discussion by now-retired Judge Arthur Gonzalez, in *WorldCom*, 2002 WL 1732646 (Bankr. S.D.N.Y. 2002), and then going on to analyze how these factors might be the same or different on *modified* DIP financing arrangements.

In addition to efforts to consider alternative financing proposals (which would generally be applicable only to *initial* financing requests, as contrasted to *modified* ones), he listed, as factors, a bankruptcy judge's ability to find:

> (1) That the proposed financing is an exercise of sound and reasonable business judgment;
>
> (2) That the financing is in the best interests of the estate and its creditors;
>
> (3) That the credit transaction is necessary to preserve the assets of the estate, and is necessary, essential, and appropriate for the continued operation of the Debtors' businesses;

Finally, a harsh truth—perhaps suspected by many—needs to be put out in the open. In at least some cases (if not the bulk of them), bankruptcy judges approach their review process on DIP financing motions[9] recognizing that they are "playing chicken" with prospective DIP lenders. The bankruptcy judge can't dictate the terms under which a DIP lender is willing to lend; the judge can say no more than if the terms aren't modified in identified respects, the DIP financing will not be approved. But bankruptcy judges are well aware of the risk that the DIP lender will refuse to lend on the terms required by the bankruptcy judge—raising a risk of an outcome like that in *American Remanufacturers*. Bankruptcy judges deal with that risk with the benefit of their experience—in most cases knowing how far they can push to improve the DIP financing without an inordinate risk that their expectations will prove to be unrealistic, and that the judicial requirements will lead to no DIP financing at all.

In at least the great bulk of cases (and especially if the prospective DIP lender is also a prepetition lender, and needs the chapter 11 case to succeed to achieve a meaningful recovery on that prepetition debt), the bankruptcy judge will succeed in obtaining a better DIP financing facility, without cratering the chapter 11 case.

> (4) That the terms of the transaction are fair, reasonable, and adequate, given the circumstances of the debtor-borrower and the proposed lender; and
>
> (5) That the financing agreement was negotiated in good faith and at arm's length between the Debtors, on the one hand, and the Agents and the Lenders, on the other hand.

294 B.R at 881.

[9] This is less of a concern on cash collateral motions, because the money already has been lent, and the bankruptcy judge can authorize the use of cash collateral without the secured lender's consent or cooperation, subject only to the lender's rights of appeal.

B. Making the DIP Financing Presentation

Notwithstanding the mass of First Day Motions paper that normally will have to be reviewed on the first day of a case, it's safe to assume that bankruptcy judges will have reviewed the financing motion and proposed financing order with care. That underscores the importance of carefully drafted motion papers, and also provides you with the luxury of shortening your oral presentation of basic matter, concentrating instead on the "hot button" matters that will be of concern to the typical bankruptcy judge. If you've prepared your papers properly, you'll have laid out in your motion papers—with affidavit or declaration support—what steps were taken to achieve the best DIP financing available (in the case of a DIP financing approval request), and the uses to which cash collateral will be put (in the case of a cash collateral request). In many cases, facts relating to those elements of the necessary showing are the most important, but at the same time they are often the facts as to which bankruptcy judges will be least likely to second-guess the estate.

With many judges, presentation of such critical matter by affidavit or declaration will obviate the need for live testimony with respect to it. But local practices vary, and in some districts practices vary even by judge. So until you know the judge who will hear the case, and what practices will be followed with respect to evidentiary presentations on undisputed facts, you will need to have a witness on hand with sufficient first-hand knowledge to testify if that is required. But assuming that you've been sufficiently comprehensive in your motion papers, you can and should minimize your discussion of uncontroversial matter, and focus on "hot button" issues that are likely to be of concern to any bankruptcy judge.

We all know what those "hot buttons" are. They include, among others rights granted to the senior secured lender (typically to the detriment of any junior secured lenders, and, of course, unsecured creditors):

- rollups;
- cross-collateralization provisions;
- liens on avoidance actions;
- waivers of rights to challenge liens;
- 506(c) waivers;
- prohibited uses of DIP financing proceeds or cash collateral (such as to investigate secured creditor liens, or to litigate against the secured lender —though this latter requirement, once duly disclosed, is not infrequently regarded as benign);
- some kinds of events of default;
- some kinds of change-of-control provisions;
- some kinds of provisions authorizing professional fees without a means for any kind of judicial scrutiny at all;
- provisions granting lender remedies upon events of default that leave the estate and junior creditors with no or minimal notice to challenge the existence of the default;
- provisions that tie the hands of the bankruptcy judge, or impose draconian consequences for actions the court might need to take; and
- milestones.

Even though some on the list are now customary, and none is impermissible under all circumstances (though in each case the devil is in the details), all of these should have been disclosed in the written motion papers—preferably by proactively stating why they are necessary or at least appropriate in this particular case, and how they have been

limited to conform to any local substantive requirements. And the most important of them should also be addressed orally.

C. Questions to be Prepared to Answer

As important as the matters that competent counsel will proactively present are others counsel should be prepared to address when questioned by the judge. Certain questions are foreseeable. Some would be directed to debtor's counsel; others would go to secured lender counsel. They include:

- What's the nexus between the most likely loss the senior secured creditor client is likely to suffer, and the adequate protection that's proposed?
- Is the entitlement to adequate protection limited to the diminution in the value of the collateral?
- Are any adequate protection payments to be made refundable to the extent they exceed the diminution in the value of the collateral?
- Are the liens granted to secure the DIP loan and the assets from which the SuperPri will have priority congruent in their coverage? Have you considered the consequences if they're not congruent? What's the purpose of any limitation or carve out from liens, for example, if a broad SuperPri will grab all of the value anyway?
- Why does the senior secured creditor need a lien on avoidance actions? Does the need for it trump junior creditors' need to resort to avoidance actions for what may be their only source of recovery?
- Should any liens on avoidance actions be on the actions themselves, or just the proceeds of any recoveries?
- Is the beneficiary of any liens on avoidance actions also given control over their prosecution?
- (In a multi-debtor case with DIP financing), what benefit will debtors who are not getting loan proceeds be getting in exchange for being borrowers under the DIP loan (or guarantying it)—and, where applicable, hocking their assets to secure it?
- What provisions have been made with respect to intercompany obligations that might result (or should result) by reason of any debtor's repayment of debt incurred by another debtor?

- To what extent will non-debtor affiliates receive DIP financing proceeds or cash collateral? What, if any, consideration will non-debtor affiliates be providing for such? What protections will the estate receive with respect to funds leaving the estate?

D. What to Never Tell a Bankruptcy Judge

Then there are some things to *never* tell a bankruptcy judge:

- "We always get this."[10]
- "That's the way they [or worse yet, "we"] do it in Delaware and New York."[11]
- "You'll find it in lots of orders, which we'd be happy to provide."[12]
- "We're oversecured. We should be getting this anyway."[13]
- "If we don't keep getting these payments [typically as an argument for receiving postpetition interest as "adequate protection"], we'll need to report this as a nonperforming loan.[14]

E. Some Final Pointers

Years of doing this—and of discussions with fellow bankruptcy judges, who've shared their frustrations in dealing with financing motions—suggest some other things

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10 Cases are fact specific, and judges raise concerns as to particular provisions for a reason. And frankly, whether you "always get this" is a matter of indifference to the judge.

11 Wholly apart from how offensive this is, it fails to take into account the different caselaw and Local Rules that may be applicable from Circuit to Circuit and District by District, and, once again, the fact-specific context in which these motions are considered.

12 Apart from the need to present any and all authority up front (especially if relief is required on the first day), many (and perhaps most) judges will not rely on the content of orders, as contrasted to opinions, in the absence of information to the judge concerning whether the order was entered on notice; whether it was opposed; whether it was entered on a preliminary or final hearing, where applicable; and whether the provision in question was focused upon by the judge. Orders, by their nature, are of greatly lesser precedential value than opinions.

13 Bankruptcy judges are not infrequently told, at the beginning of a case, that a secured creditor or creditor group is oversecured, only later to find out that its collateral was worth less than originally thought. Also, at least some bankruptcy judges believe that the more a secured creditor is, in fact, oversecured, the less it needs, or should get, adequate protection.

14 This is a matter of indifference to a bankruptcy judge, and especially an insufficient reason to prejudice other creditors.

practitioners might want to consider in presenting financing motions. In the written motion papers (and proposed order):

- Format the borrowing agreement, and related order, so each can be read without undue difficulty and delay. That means lots of headings and subsections. It means avoiding massive blocks of text—particularly paragraphs that run on for a page or more. It means keeping paragraphs short. And it means breaking matters in enumerations and lists into subparagraphs or further subdivisions (indented, spaced and otherwise formatted to ease understanding of the structure of the paragraph). (Formatting it in that fashion will also help you minimize ambiguities.)

- **Bold** your defined terms (and don't just surround them with quotes, or even with quotes and underlining alone), so they can be easily found when the judge needs to refer back to them.

- Don't use acronyms, unless they are obvious. They'll be too difficult to decipher for a judge who hasn't been living with a case.

- Don't expect the typical multi-page (and, typically, highly legalistic) term sheet to meet Local Rules' requirements for highlighting key provisions. Rather, list the hot button items (which typically are expressly identified in Local Court Rules) in separate, short, paragraphs, without camouflaging them in any way.

- Keep your orders as short as possible. And make them free-standing, so the judge doesn't need to go back and forth between the order and the lending agreement.

- Normally, the judge will prefer that a DIP financing order trump the postpetition loan agreement (or anything said in the financing motion) in the event of any inconsistencies. If that isn't to be the case, bring that to the attention of the judge, and explain why.