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STANDARDIZING AND UNBUNDLING THE SUB ROSA DIP LOAN

Kenneth Ayotte

Alex Zhicheng Huang[*]

ABSTRACT

In many recent chapter 11 cases, debtor-in-possession ("DIP") loans determine reorganization plan payoffs at the outset of the case. Recent DIP loans are tied to plan terms including rights offerings, which give the DIP lender exclusive rights to purchase discounted equity in the reorganized company, and backstop fees, which pay the rights holder for committing to purchase them. Terms like these raise fears that DIP loan approval is being used to short circuit the chapter 11 reorganization plan process—in bankruptcy parlance, that the DIP loan is a sub rosa plan. How should bankruptcy law manage this sub rosa DIP loan problem?

We argue that the problem is a common one affecting many types of pre-plan transactions that provide the estate with an asset (cash) but also fix the priority and/or payoff of liabilities. We argue that bankruptcy law uses a common set of tools to deal with these crossover transactions *that simultaneously involve asset-side and liability-side effects. Where crossover is inherent to the transaction, the Bankruptcy Code* standardizes *the liability-side effect to protect the interests of the other creditors. Where crossover is strategic, courts police transactions by* unbundling *liability-side effects that are unnecessarily bundled into transactions involving the asset side.*

We conduct a case study of the J.C. Penney bankruptcy to understand how a non-standard, bundled DIP loan transaction can be used strategically to distort priorities. In that case, a DIP loan tied to a restructuring support agreement allowed a majority group to prime a minority group, roll up undersecured debt,

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and control the allocation of payoffs in the case. We find that a standardized, unbundled DIP loan would have required an interest rate of at least 545% to give the majority group the same payoff it received in the case. We argue that courts should revive and strengthen standardization and unbundling norms. This would better defend priorities by encouraging competition and increasing transparency of DIP loan terms.

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INTRODUCTION

Imagine the following alternative to chapter 11. The debtor arrives in court at the first day hearing and announces which of the existing creditors they recommend to receive the "golden ticket." The golden ticket gives the recipient full ownership of the company's assets, free from the claims and interests of any other creditors. The judge verifies that the ticket holder is a creditor, but otherwise defers to the debtor's judgment as to how the winner is chosen; the amounts and priorities of the prepetition claims need not play any role in determining the winner.

Today's chapter 11 is not "golden ticket bankruptcy" yet, but it is quickly approaching it. Through DIP loans tied to reorganization plan outcomes, early stage hearings about DIP loans bear increasing resemblance to golden ticket hearings, allowing the debtor and its chosen DIP lender coalition to determine both the fate of the bankrupt firm and the lenders' own payoffs in the reorganization plan. Sometimes, this is done directly through terms in the loan agreement itself. Another common device is tying the DIP loan to a restructuring support agreement ("RSA").[1] The RSA conveys control rights to a subset of the creditors during the case and outlines payoffs to creditors in the eventual plan. Plan payment rights tied to DIP loans often include exclusive rights to purchase equity at a substantial discount to the plan values (rights offerings) and fees for making this commitment (backstop fees).[2] Deviation from the RSA is an event of default under the DIP loan, so that pursuit of any other path risks immediate liquidation.

It is easy to understand why chapter 11 is moving in the direction of the golden ticket. Golden ticket bankruptcy would be ideal for achieving bankruptcy's asset-side goal: maximizing the value of the bankruptcy estate. Being an undivided owner of the company, the golden ticket holder would keep the firm alive whenever it is more valuable that way. Intercreditor disputes would vanish, along with the uncertainty and cost they create. Debtors and DIP lenders make exactly these arguments in seeking approval of the modern DIP loan. The RSA guarantees consensus among its signatories, they argue, reassuring key stakeholders that the company has a clearer and faster path to

[1] A restructuring support agreement (RSA) is a contract between the debtor and a subset of its creditors, committing its signatories to support a particular reorganization plan.

[2] A backstop is a guarantee that the party will agree to purchase securities in the rights offering if it is undersubscribed; the backstop party receives a fee for providing this guarantee.

emergence. This eliminates cost and uncertainty that might put the company's very survival at risk.

Of course, the main cost of this approach is the respect for priorities, bankruptcy's main liability-side goal. Though the absolute priority rule is considered the sine qua non of bankruptcy, the benefits of defending priority are much harder to see. They are mostly realized before the bankruptcy occurs, and through less apparent channels, such as greater access to credit and lower costs of capital for healthy firms.[3] By the time the company approaches the bankruptcy judge for approval of the DIP loan, priority challenges appear to be no more than a tug-of-war between sophisticated investor groups. If proponents pit the company's survival against these indirect benefits, it is easy to see why approved DIP loans look more and more like reorganization plans.

If defending priorities is to remain a serious goal of chapter 11, however, courts must develop strategies to confront the sub rosa DIP loan problem. Luckily, the underlying problem is not a new one. It is merely a polar case of the common problems that pertain to the pre-plan transactions we call *crossover transactions.* Crossover transactions are ones that simultaneously implicate an asset-side decision (the use or exchange of an estate asset) and a liability-side decision (determining a creditor's priority and/or payoff). DIP loans are inherently crossover transactions under this definition: They provide a new asset for the estate (cash), but they also require giving the DIP lender a new obligation whose value and priority will affect the creditor body as a whole.

Crossover transactions are challenging because procedures tailored to asset-side and liability-side goals are inherently in tension.[4] Preserving asset value during a bankruptcy case requires time-sensitive decisions and deference to management. Bankruptcy asset value can dissipate quickly if a key asset is lost. Chapter 11's debtor-in-possession model is founded on the belief that the debtor's management is best placed to make these crucial, time-sensitive business decisions.[5] Hence, the law defers substantially to management's judgment.

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3 *See infra* Section IV.

4 The Supreme Court recognized this tension in the *Jevic* case. It reinforced the need to defend priorities by rejecting a priority-skipping structured dismissal. But the Court limited its holding to end-of-case distributions, leaving flexibility for debtors in the pre-plan transactions we analyze here. *See* Czyzewski v. Jevic Holding Corp., 580 U.S. 541 (2017).

5 *See infra* Section III on how asset-side decisions are faster and more deferential to management under business judgement rule.

Liability-side procedures intended to defend priorities, on the other hand, require multilateral negotiation and time. Because plans may distribute complex securities based on uncertain and disputed asset values, plan valuation disputes can require more time to resolve. And because management has no special expertise or incentive to defend priorities, management's prerogative yields to the creditors, who have explicit voting rights regarding liability-side decisions.[6]

There are no silver bullet solutions to the crossover transaction problem. But we suggest that courts revive two strategies that would help restore balance between asset value preservation and respect for priorities. Both of these strategies are already part of bankruptcy law's norms. And they can be applied with varying degrees of strength depending on the facts at hand, making them more implementable than an all-or-nothing approach.

The first strategy is *standardization.* Some transactions are inherently crossover transactions. If the debtor wants to finance new postpetition assets, for example, it must create a new obligation on the liability side to compensate the asset provider. In these cases, the Bankruptcy Code (the "Code") typically provides a standardized way to govern them. The general approach is to defer to management's judgment regarding the asset side of the transaction, but to standardize the priority and amount of the liability to defend the nonparticipating creditors.[7] The Code's treatment of administrative expenses, executory contracts, and DIP loans reflects this standardization approach.

Regarding DIP loans in particular, section 364's standardization mechanism regulates the way DIP lenders can receive compensation for their loan.[8] It requires that the DIP lender be paid in the form of debt, and it sets up a structure to determine the priority of that debt claim against the other creditors.[9] To protect

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6 *E.g.*, 11 U.S.C. § 1125 (requiring adequate information disclosure); 11 U.S.C. § 1126 (describing voting rules); 11 U.S.C. § 1129 (outlining plan-confirmation standards).

7 *See infra* Section III on the distinction between asset-side decisions and liability-side decisions.

8 *See* George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901, 903 (1993) ("[S]ection [364] is primarily a *constraint* on the financing decisions of the debtor in possession, designed to replace the prebankruptcy controls provided by debt covenants." (emphasis in original)).

9 *See* 11 U.S.C. § 364(b), (c). The text of these sections is reproduced below.

> (b) The court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) of this section, allowable under section 503(b)(1) of this title as an administrative expense.
>
> (c) If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt—

the other creditors, section 364 requires that the DIP lender's priority is capped at the lowest priority necessary to access the funds.[10]

A more rigorous defense of section 364's standardization scheme would have important benefits. Standardization makes it possible to put transparent bounds on the cost and risk of the loan to the non-DIP creditors in the time-sensitive fashion that DIP loan approval requires. When only standard, plain-vanilla debt claims are allowed, then the maximum cost of the loan to the other creditors would be the principal and the interest. The transparency of payment through debt, then, makes the cost to the other creditors less subject to opportunistic value diversion. Standardization also promotes competition by allowing for a clearer comparison of the loan to alternative proposals and precedent transactions.[11]

Paying a DIP loan with equity-linked securities, by contrast, can dilute the claims of nonparticipating creditors to an extent that a court has no realistic way to determine at the outset of a case. Lenders will have superior information about the value of the bespoke compensation they propose for themselves; hence, they will propose non-standard terms exactly when it is likely to benefit them most.[12]

> (1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;
>
> (2) secured by a lien on property of the estate that is not otherwise subject to a lien; or
>
> (3) secured by a junior lien on property of the estate that is subject to a lien.

Id.

[10] Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 668 (2020) ("Section 364 suggests a general constraint on the use of inducements: the debtor may extend only as much inducement as is necessary to obtain the desired DIP financing. The debtor must show that no lesser inducements would suffice—at least in theory. This approach recognizes that inducements are not costless; they can take value away from junior claimants.").

[11] The justification we offer for standardizing bankruptcy law transactions is similar to the rationale for standardization in other legal domains. Although non-standardization may allow for greater information richness, such as more customized pre-plan transactions, it inevitably leads to higher information costs. In the domain of property law, for instance, the numerus clausus limits property rights to a few standardized forms. This eliminates the need for third parties to expend time and resources to determine the attributes of these rights, either to avoid violating them or to acquire them from current holders. Consequently, the numerus clausus system avoids the high cost of processing information about all property rights. Thomas W. Merrill & Henry E. Smith, Optimal Standardization in the Law of Property: The Numerus Clausus Principle, 110 YALE L.J. 1, 30 n.117, 32–33, 43–51 (2000); Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 MICH. L. REV. 1175, 1175-79 (2006); Henry E. Smith, Standardization in Property Law, in RESEARCH HANDBOOK ON THE ECONOMICS OF PROPERTY LAW 148 (Kenneth Ayotte & Henry E. Smith eds., 2011).

[12] Readers may recognize that this is the familiar adverse selection or "lemons" problem, but in reverse: We suggest that the financier will have superior information about the value of information-sensitive securities it proposes to the borrower. *See* Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment*

Moreover, the de facto priority of the DIP lender, through the fixed discount to uncertain plan value and the dilution of the value of nonparticipating debt, cannot be meaningfully compared to the priority rankings that section 364 permits. As such, rights offerings as DIP loan compensation fit nowhere within section 364's priority-capping hierarchy. Courts should not permit these nonstandard forms of repayment.

Our second strategy, *unbundling*, is bankruptcy law's response to strategic crossover.[13] Transactions are unbundled by refusing to approve pre-petition liability-side consequences that could be postponed to the plan. Parties have strategic incentives to bundle in liability-side add-on effects into transactions involving the asset side. Time-sensitivity is an advantage to the transaction proponent because it can be used to suppress competition and judicial scrutiny of terms. This is particularly true at the DIP loan stage, where a secured creditor's/DIP lender's leverage is at its peak. The debtor can argue that the firm needs an immediate cash infusion to survive, and there will be few rival lenders to offer better terms.[14]

Courts have applied unbundling strategies in 9019 settlements, 363 sales, and DIP loans.[15] The most well-known example of an unbundling decision is *In re Braniff Airways*, which introduced the concept.[16] In that case, the Fifth Circuit refused to permit a 363 sale that also bundled in payouts to particular creditors and locked up future votes on the plan. Unbundling is valuable because it prevents a time-sensitive asset decision from stripping creditor voting rights and disabling alternative liability-side proposals. In the DIP loan context, courts

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Decisions When Firms Have Information that Investors Do Not Have, 13 J. FIN. ECON. 187, 196 (1984). *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

[13] In a recent article, Melissa Jacoby also uses the term unbundling to describe the problem of the *à la carte* choice of bankruptcy features and the shortcutting of process that results. Here, we describe the strategic behavior as one of bundling asset and liabilities side effects into a single transaction. We argue that unbundling these effects can be beneficial. *See* Melissa B. Jacoby, *Unbundling Business Bankruptcy Law*, 101 N.C. L. REV. (forthcoming 2023), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4228060.

[14] This is often true because priming an existing secured creditor without consent is rarely approved by courts, and because an outsider secured creditor would be unlikely to lend at a junior position to existing secured creditors; this is known as the debt overhang problem. *See generally* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977). One of us in joint work shows that this problem can lead to inefficient transfers of case control to the secured lender/DIP provider. *See* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1 (2022).

[15] *See* FED. R. BANKR. P. 9019; 11 U.S.C §§ 363, 364.

[16] *See* Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983) (establishing that sub rosa plans will not be upheld).

have resisted approving cross-collateralization[17] and roll-ups,[18] which attempt to bundle prepetition claim treatment into the DIP loan package. Recently, some courts have also taken steps to unbundle RSAs from DIP loans; one court declared a DIP loan to be a sub rosa plan.[19] We suggest that courts continue this trend by refusing to allow tying of DIP loan covenants to RSA adherence. Courts should also reinforce the Eleventh Circuit's approach in *In re Saybrook Manufacturing* by refusing to permit roll-ups or cross-collateralization of undersecured debt.[20] These unbundling strategies would enable competition for rival plans and restore creditor voting rights over prepetition claim decisions.

We use a case study of the 2020 J.C. Penney bankruptcy to demonstrate the priority-distorting effects of a non-standard DIP loan bundled with an RSA. In that case, a majority group of first lien creditors made a DIP loan that primed the minority creditors and rolled up undersecured first lien debt into the priming loan. The DIP loan was tied to an RSA that gave the majority group control over the case process. This case control led to a going-concern sale via credit bid that limited potential competing bids, thus providing an above-par recovery on the majority group's super-senior claim.

We conduct a simple calculation of a counterfactual plain-vanilla DIP loan—one without the roll-up, fees, or the supranormal return on principal achieved through case control—to get a transparent measure of the value the majority diverted from the minority. With these alternative forms of compensation removed, we find that the majority group would have required an annualized interest rate of at least 545% on their first-priority DIP loan funds to achieve the same payoff. The example illustrates how an opaque bundle of rights proposed through a time-sensitive process can be used to distort priorities. It suggests the need for greater standardization and unbundling of DIP loans. This will bring the true terms of a loan to light, allowing for greater competition and judicial scrutiny of terms.

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[17] Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490, 1494–95 (11th Cir. 1992).

[18] Scholars have noted the functional similarity between cross-collateralization and roll-ups and courts' skepticism of roll-ups. *See* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 707–09 (2009).

[19] *In re* LATAM Airlines Grp., 620 B.R. 722 (Bankr. S.D.N.Y 2020) (declining LATAM Airlines' proposed DIP facility because of improper sub rosa plan treatment of the tranche C DIP lenders and debtors' equity holders).

[20] *See Saybrook Mfg.*, 963 F.2d at 1494–95.

I. RELATED LITERATURE

Our Essay contributes to the literature on DIP loans and the controversies surrounding terms bundled on to them, like roll-ups and cross-collateralization. This literature has not emphasized the benefits of standardization of DIP loan terms to promote transparency and competition, however. The increasing use of equity-linked payment for DIP loans brings this issue to the forefront. There is also a growing literature analyzing the more recent developments regarding RSAs.[21] In joint work with Jared Ellias, one of us documents the rise of DIP loans tied to RSAs and tests a theory based in the debt overhang problem to explain the strategic value of case control.[22] In this Essay, we highlight not just the control aspect of RSAs but also the use of RSAs to determine plan payouts.

More generally, our work contributes to the theoretical law and economics literature on corporate bankruptcy. Two closely related papers in the same spirit as ours are Mark Roe and Frederick Tung's work on priority jumping activity[23] and Melissa Jacoby and Edward Janger's work on "hurry up" 363 sales.[24] Our framework is similar to Roe and Tung's in describing the rent-seeking activity from contractual and legal innovations such as roll-ups, critical vendor orders, and 363 sales. Jacoby and Janger's work discusses the trade-offs between the need for speed on the asset side and the cost of procedural shortcuts on the liability side. In the modern era, the pre-plan transactions we describe in cases like *J.C. Penney* are the hurry up sale problem on steroids. On the asset side, the melting ice cube threat is replaced by the more severe threat that the firm will collapse completely due to lack of financing. On the liability side, the use of the DIP-RSA pairing to restructure liabilities can have more direct and consequential effects on priority than an asset-for-asset 363 sale.

Relative to this work, a novel contribution of our approach is the framing of bankruptcy's goals based on the assets and liabilities sides of the debtor's

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21 *See, e.g.*, Douglas G. Baird, *Bankruptcy's Quiet Revolution*, 91 AM. BANKR. L.J. 593 (2017); Edward J. Janger & Adam J. Levitin, *Badges of Opportunism: Principles for Policing Restructuring Support Agreements*, 13 BROOK. J. CORP. FIN. & COM. L. 169 (2018); David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366 (2020).

22 Ayotte & Ellias, *supra* note 14.

23 *See generally* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain.* 99 VA. L. REV. 1235 (2013).

24 *See generally* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014).

balance sheet,[25] which ultimately allows us to identify the pre-plan crossover transaction as a common strategic source of priority jumping. Our approach illuminates the common strategies of standardization and unbundling[26] that the Bankruptcy Code and courts use to manage crossover transactions in various forms.

II. THE J.C. PENNEY BANKRUPTCY

J.C. Penney filed for chapter 11 in May 2020, one of many underperforming and highly-leveraged retailers that fell victim to COVID-related lockdowns. The company had, at time of filing, a storied 118-year history, beginning with the dry goods store in Kemmerer, Wyoming that its founder, James Cash Penney, opened in 1912. At its peak in the 1970s, the retailer operated over 2,000 stores.[27] In the 2010s, strategic missteps and several rebranding attempts failed, leading to four different CEOs over a seven-year period from 2011 to 2018. At the time of its filing, the company continued to operate over 800 stores and employed over 85,000 people. It faced an uncertain future and little ability to generate cash due to the pandemic: April year-over-year revenues were down 88%, and over 90% of its employees had been furloughed.[28]

The company's capital structure consisted of approximately $4.9 billion in funded debt. The most important for our purposes were a $1.2 billion secured asset-based loan ("ABL"), a $1.5 billion first lien term loan, and $500 million in first lien notes that had equal rank to the first lien term debt. Below those claims in the priority waterfall were $400 million in second lien notes, and $1.3 billion in unsecured debt.[29] Given the enormous decline in the company's asset value, it was clear from the outset that asset value was insufficient to pay even the first

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[25] Conceptually, our balance sheet perspective is most similar to Vincent Buccola's work contrasting the discretion and entitlement paradigms, which are analogous to our asset-side and liabilities-side goals. *See generally* Vincent S.J. Buccola, *The Janus Faces of Reorganization Law*, 44 J. CORP. L. 1 (2018); Vincent S.J. Buccola, *Unwritten Law and the Odd Ones Out*, 131 YALE L.J. 1385 (2022).

[26] Ralph Brubaker and Charles Tabb have been the most consistent opponent of what we call unbundling strategies. *See* Ralph Brubaker & Charles J. Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375; Charles J. Tabb, *What's Wrong with Chapter 11?*, 71 SYRACUSE L. REV. 557 (2021).

[27] *J.C. Penney Company, Inc. History*, FUNDING UNIVERSE, http://www.fundinguniverse.com/company-histories/j-c-penney-company-inc-history/ (last visited Mar. 7, 2023).

[28] Declaration of Bill Wafford, Executive Vice President, Chief Financial Officer of J.C. Penney Co., Inc., in Support of the Debtors' Chapter 11 Petitions and First Day Motions, at 4, 24–25, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. May 15, 2020), ECF No. 25. [hereinafter Declaration of Executive Vice President].

[29] *Id.* at 36.

lien debt in full: This debt traded below forty cents on the dollar at the time of the filing.[30]

The first lien debt was held by numerous institutional investors. A group of these lenders led by the hedge fund H/2 Capital Partners, holding approximately 70% of the first lien debt, formed a majority coalition.[31] Through a DIP loan connected to an RSA, the majority was able to divert a significant amount of value from the minority coalition. We describe the features of the two transactions in turn.

A. The DIP-RSA Bundle

The loan was a complex bundle of terms. The most controversial of these was the combination of a priming lien and a dollar-for-dollar roll-up of the first lien prepetition debt, offered to only the majority lender group. The priming lien component elevated the priority of the majority's new money DIP loan of $450 million above the minority's first lien debt. And the roll-up component of the DIP loan elevated another $450 million in the majority lender group's prepetition debt.[32] The effect resembled that of similarly controversial "uptiering" transactions in Serta Simmons and others that had taken place outside of bankruptcy, in which a majority in a lender group exchanged its debt for new debt that ranked ahead of the minority's debt.[33]

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30 *See* Objection of the Ad Hoc Crossholder Group to the Debtors' Emergency Motion for Entry of (I) an Interim and Final Order (A) Authorizing Debtors to Use Cash Collateral, (B) Granting Adequate Protection to the Prepetition Secured Parties, and (C) Scheduling a Final Hearing; and (II) a Final Order (A) Authorizing the Debtors to Obtain Postpetition Financing Pursuant to Section 364 of the Bankruptcy Code, (B) Granting Liens and Superpriority Claims, (C) Modifying the Automatic Stay; and (III) Granting Related Relief, *In re* J.C. Penney Co., at 1–2, No. 20-20182 (Bankr. S.D. Tex. June 2, 2020), ECF No. 469 [hereinafter Crossholder Group Objection].

31 Transcript of Emergency Motion for Entry of (I) Interim and Final Order (A) Authorizing Debtors to Use Cash Collateral, (B) Granting Adequate Protection to the Prepetition Secured Parties, and (C) Scheduling a Final Hearing; and (II) Final Order (A) Authorizing the Debtors to Obtain Postpetition Financing Pursuant to Section 364 of the Bankruptcy Code, (B) Granting Liens and Super Priority Claims, (C) Modifying the Automatic Stay; and (III) Granting Related Relief, at 13, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. June 5, 2020), ECF No. 563 [hereinafter DIP Hearing Transcript].

32 Declaration of Executive Vice President, *supra* note 28, at 12.

33 Vincent S.J. Buccola & Greg Nini, The Loan Market Response to Dropdown and Uptier Transactions 34–35 (June 22, 2022) (unpublished manuscript), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4143928; *see also* Samir D. Parikh, *Financial Disequilibrium*, 171 U. PA. L. REV. (forthcoming 2023) (manuscript at 29–32) (detailing up-tiering transactions employed by Trimark and Envision Healthcare), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4323945.

The proposed DIP loan was also tied to an RSA that contemplated a two-track reorganization procedure.[34] If the debtor presented a business plan that satisfied the majority lender group by mid-July, they could reorganize. If not, the DIP loan would be in default, and the case would proceed to an immediate 363 sale of the assets that might liquidate the company. In effect, the RSA gave the majority lenders the sole discretion to decide whether J.C. Penney would reorganize or liquidate.

A group of crossover lenders, holding a minority of the first lien debt and second lien debt, objected to the DIP loan proposal.[35] The group argued that the loan constituted a sub rosa plan, because it committed the company to a case process that served only the majority lenders' interests, and that the DIP loan violated terms in the Term Loan and intercreditor agreements requiring equal treatment among the lenders. They also objected to the excessively high interest rate, compounded by five separate classes of fees. The largest of these was a $45 million up-front fee, equal to 10% of the potential $450 million in new money.[36] These fees would further depress the value of the minority first lien debt, cutting into their recovery.

To further buttress their objections, the crossover group offered a competing DIP loan proposal.[37] Because the majority group's DIP loan proposal was complex, the crossover group structured its alternative to be superior along each of eight dimensions, including the amount of credit availability, the five classes of fees, and the interest rate. They also argued that the lack of a tie to the RSA gave the debtor added flexibility to determine its own course of the reorganization.

But there was one feature that the crossover group could not possibly match: majority consent to the priming DIP loan. The debtor and majority lenders argued that this difference was paramount—and their argument made strategic use of time-sensitivity.[38] Without majority consent to the priming lien, the

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[34] Declaration of Executive Vice President, *supra* note 28, at 22.

[35] *See* Crossholder Group Objection, *supra* note 30.

[36] Other fees included an exit premium, an exit loan commitment premium, and an exit loan upfront premium. The crossover minority group estimated the total dollar cost of these fees at $117 million. *See id.* at 20.

[37] *Id.* at 4–6.

[38] Omnibus Reply of Ad Hoc Group of First Lienholders to Objection of (A) Ad Hoc Crossholder Group, (B) Official Committee of Unsecured Creditors, and (C) Certain Landlords to the Debtors' Motion for Entry of Final Order (1) Authorizing the Debtors to Obtain Postpetition Financing Pursuant to Section 364 of the Bankruptcy Code, (2) Granting Liens and Super Priority Claims, at 8–9, *In re* J.C. Penney Co., No. 20-20182

crossover group would need to win a priming fight under section 364(d).[39] This priming fight, they argued, would involve a time-consuming and risky valuation contest, because the debtor would need to show that the majority group's primed liens were receiving adequate protection. And if they failed, the debtor's business would be placed at risk, because the company's vendors[40] and ABL lenders[41] could withdraw their support. As the majority lenders argued: "It is therefore entirely understandable that the Debtors concluded that they were simply not willing to bet the company (and 85,000 employees) on their ability to win an adequate protection fight against the holders of 70+% of their First Lien Debt."[42]

Ultimately, on the day of the DIP loan hearing, the minority lenders reached a settlement that provided for a partial roll-up of the minority lenders' first lien

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(Bankr. S.D. Tex. June 4, 2020), ECF No. 512. [hereinafter Reply of Ad Hoc Group of First Lienholders]; *see* DIP Hearing Transcript, *supra* note 31, at 15, 31.

39 11 U.S.C. § 364(d) provides that:

> (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—
>
> > (A) the trustee is unable to obtain such credit otherwise; and
> >
> > (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
>
> (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

Section 364(d)(1)(B) states that a court "may authorize the obtaining of credit or the incurring of debt . . . only if . . . there is adequate protection" of the senior lender. To offer priming liens to the DIP lender, the debtor must provide evidence of adequate protection for pre-bankruptcy lenders whose liens are subordinated to the priming DIP lender's new liens.

40 *See* DIP Hearing Transcript, *supra* note 31, at 52 ("Q: Has the debtors' lack of DIP financing during this interim period caused any issues with the company's vendors? A: Yes, it has . . . our vendors have been concerned about the lack of having a DIP . . . . And that is causing us issues. We haven't received as much shipments as we had predicted during this time frame." (testimony of James Mesterharm, Managing Director, AlixPartners)).

41 One reason for this, according to the debtors' financial advisors, is that the company's ABL lenders, who were not directly involved in the priming fight, would refuse to consent to use of their cash collateral if the priming fight occurred. *See* DIP Hearing Transcript, *supra* note 31, at 15 ("First, it requires authority to use cash collateral over Wells' objection. And as noted in this email from Mr. Fiorillo on behalf of Wells Fargo, there was no world in which Wells Fargo would agree if we toggled ourselves to the crossholder proposal th[at] they would support the fight that would ensue in order to achieve approval of that financing. And that's because the financing with the crossholder group, which is supported by only 16 percent of our first liens, would necessitate a nonconsensual priming and valuation fight. That would include fresh, brand new appraisals on all of our unencumbered property, valuation testimony, expert testimony, depositions, and a lot of time. And as noted in Mr. Fiorillo's email, he notes that the cost to this estate and the time to this estate is not something that Wells Fargo is prepared to support." (statement of Joshua A. Sussberg, debtor's counsel)).

42 Reply of Ad Hoc Group of First Lienholders, *supra* note 38, at 3.

loan.[43] The court approved the DIP loan and overruled all remaining objections, reasoning that in a retail case, time was of the essence,[44] and the company's survival was not worth sacrificing to unnecessary disputes.[45]

B. The Sale/Credit Bid

The DIP loan and RSA set the stage for the sale process that occurred later in the case. The RSA contemplated an OpCo/PropCo structure, whereby a third party would take ownership of the J.C. Penney operating companies. The PropCo would own J.C. Penney's real estate and lease it to the OpCo. After canvassing the market for buyers in the summer of 2020, J.C. Penney reached an agreement with its two largest landlords, the real estate companies Simon and Brookfield, that would allow the company to exit bankruptcy as a going concern.[46]

Time sensitivity also played an important role in the sale transaction.[47] The debtor argued that it was crucial that Simon and Brookfield take control of the company before the holiday season started. This would reassure vendors and allow for the company to replenish its depleted inventory ahead of the holiday season. As with the DIP loan, the debtor sought to implement this transaction using another opaque transaction on a rapid timeline.

There were a few key elements to the sale transaction that further diverted value to the majority group at the expense of the minority group. First, the parties would set up a bidding entity that would purchase nearly all of J.C. Penney's assets for a credit bid of $1 billion. Because of the dollar-for-dollar roll-up of the first lien debt, the majority group was able to make a $900 million credit bid

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[43] *See* Notice of Filing of Settlement Agreement with the Minority First Lien Lenders, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Nov. 6, 2020), ECF No. 1774.

[44] *See* DIP Hearing Transcript, *supra* note 31, at 160 ("And as we sit here today, we still don't know where the ultimate destination of J.C. Penney's is. What I am confident of is that if there isn't a [DIP loan] package going forward, I know what the ultimate answer is. I've been involved in enough retail cases in my career as a lawyer to understand what time does to a retail case." (statement of the court)).

[45] *See id.* at 161 ("I will not let this case languish. I will not let it become bogged down in fights that fail to recognize the big picture and what's at stake." (statement of the court)).

[46] Debtors' Emergency Motion for Entry of an Order (I) Scheduling Hearings and Deadlines with Respect to the Restructuring Transactions and (II) Granting Related Relief, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Sept. 30, 2020), ECF No. 1503 [hereinafter Debtors' Emergency Motion for Entry of an Order].

[47] *See* [Transcript of] Status Conference and Disclosure Statement Hearing, at 41, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Oct. 29, 2020), ECF No. 1687 ("The reality of the situation is, Your Honor, that the operating company needs to close because this buyer has determined that it needs to own it during the holiday season." [hereinafter Transcript of Status Conference and Disclosure Statement Hearing] (statement of Andrew Leblanc, counsel for the Ad Hoc Group of First Lien Lenders)).

using the DIP loan. Only $100 million of the $1 billion bid would be credited to the first lien debt, held in part by the minority group. The majority group was able to decide on this value split unilaterally, because they controlled a majority of both the DIP loan and the first lien debt. This meant that the value of J.C. Penney assets acquired through the credit bid would be divided according to a 90/10 split, with 90% of the value going to the DIP lender group and only 10% going to the first lien debt.[48]

Second, the sale bundled OpCo and PropCo together, and did so without the formal bid procedure and auction process typical in 363 sales.[49] This had the effect of limiting competition from the minority lenders. The minority group could not raise financing for a cash bid that would beat the majority group's credit bid for the entire company on the short timeline the debtor argued was necessary. Hence, their defensive strategy focused on creating a higher bid for only PropCo that would increase the first lien's recovery. They argued that unbundling the PropCo sale would permit Simon and Brookfield to take control of the OpCo quickly, while maximizing the value of the assets through a value maximizing PropCo auction process through the chapter 11 plan. The debtor and majority lenders argued that this was impossible; the OpCo/PropCo sale was necessarily integrated, and needed to proceed due to time sensitivity and the risk of losing Simon and Brookfield's participation. They argued that the canvassing of the market for buyers in the prior five months of the case provided a sufficient market test of the deal.

The minority lenders were incensed by this strategy, arguing that the DIP lender group's bid was "reeking of not only greed, but abhorrent bad faith."[50] They complained of the "intentionally convoluted structure"[51] and the artificially rushed sale process.[52] By their estimates, the DIP lenders would

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48 Objection of the First Lien Minority Group to Approval of Debtors' Emergency Motion for Entry of an Order (I) Scheduling Hearings and Deadlines with Respect to the Restructuring Transactions and (II) Granting Related Relief, at 3, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Oct. 5, 2020), ECF No. 1532 [hereinafter First Lien Minority Group Objection].

49 See *id.* at 19 ("The one thing that is clear from the Scheduling Motion is that the Debtors intend to sell all or substantially all of their assets and distribute the proceeds thereof in approximately six weeks with no bidding procedures or formal sale or auction process.").

50 *See* Statement of the First Lien Minority Group Regarding the Debtors' Sale Motion and Limited Objection to Approval of the Disclosure Statement, at 2, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Oct. 23, 2020), ECF No. 1621.

51 *See id.* at 12.

52 *See* Transcript of Status Conference and Disclosure Statement Hearing, *supra* note 47, at 21 ("To delay for five months and then tell everybody, we have to hurry up and close and this is our only option because it's

receive a recovery of over 160%, while the first lien lenders would receive only a 10% recovery.

Again, they characterized the transaction as a sub rosa plan intended to evade plan confirmation requirements. In particular, the strategy of finalizing the sale through section 363—instead of through standard plan confirmation mechanisms—freed the debtor having to comply with from having to provide a valuation demonstrating that the minority lenders received their liquidation value entitlement as required under section 1129(a)(7)'s best interest of creditors test.[53] But ultimately, the minority lenders settled their objections for a $40 million cash payment, and the sale went forward as planned. J.C. Penney survived, and the majority's case control strategies reaped a handsome reward.

C. *Measuring Value Diversion: An Interest Rate Approach*

Because the DIP loan and the sale process were quite opaque, it is difficult to understand exactly how much value the majority group was able to redistribute from the minority through the reorganization strategies employed in the *J.C. Penney* case. The majority's payoff came through a combination of fees, a roll-up of undersecured debt, and a credit bidding strategy, enabled by the RSA, that provided a greater than 100% return on the loan principal.[54] One way to make the true terms more transparent is to imagine a simpler, plain-vanilla DIP loan that generates an equivalent payoff. Suppose that all of the reorganization value received by the majority, and not the minority, is effectively a repayment on the new money that the majority group advanced through its DIP loan. If we do this, and assume that any payment in excess of principal is interest on the loan, we can work backwards to calculate an effective annualized interest rate.

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almost Christmas, it's a problem of their own making." (statement of Matthew Okin, counsel for the Ad Hoc Committee of Equity Interest Holders)).

[53] Section 1129(a)(7) requires that all creditors receive at least liquidation value. *See* Ad Hoc Equity Committee's Objection to Confirmation of Amended Joint Chapter 11 Plan of Reorganization of J.C. Penney Company, Inc. and Its Debtor Affiliates, at 6–7, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Nov. 21, 2020), ECF No. 1980 [hereinafter Ad Hoc Equity Committee's Objection] ("The Debtors have opted not to provide a liquidation analysis or any substantive evidence on this point . . . . Instead, the Debtors assume that § 1129(a)(7) is met because the Plan is essentially a liquidating plan.").

[54] Debtors' Emergency Motion for Entry of an Order, *supra* note 46; *see* First Lien Minority Group Objection, *supra* note 48.

A back-of-the-envelope calculation is as follows.[55] The DIP lenders made a new loan of $450 million to the debtor, less an upfront 10% fee of $45 million paid before the filing. Thus, the DIP lenders advanced, at most, a total of $405 million in new money.

The most important piece of our estimate is the valuation of the DIP loan. The more conservative of these is the trading price of the DIP debt, which traded at 130 cents on the dollar after the sale was announced.[56] This means the DIP loan was worth $1.17 billion ($900 million multiplied by 1.30). The DIP lenders did not receive all of this amount, because they agreed to roll up $53 million of the minority group's debt.[57] The DIP lenders' share of the loan, then, amounts to 94.1%.[58] Therefore, on the DIP loan, the majority group received consideration worth 94.1% of $1.17 billion, or $1.10 billion. We need to apply a small deduction to this payoff, because the majority group did not receive any payout through the first lien recovery on the rolled up portion of their DIP loan. This amount would have been $29 million had the roll-up not occurred.[59] The debtor also made a $40 million payment to the minority lenders to settle their sale objection; we assume this amount came from the majority group's recovery.[60] Deducting these amounts, the majority group received a payoff of $1.03 billion on the DIP loan.

This implies that the interest on the DIP loan in dollars was the difference between $1.03 billion and $405 million: $625 million. This translates into an interest rate of 154% over six months. If we annualize this six-month rate by compounding it, we get an annualized interest rate of 545% on its first priority

55 The calculation is likely quite conservative. It leaves out several assumptions that would increase the interest rate estimate: a) it does not include any interest paid on the DIP loan during the case; b) it does not assume payment on any fees other than the upfront 10% fee; c) it assumes the entire $405 million in new money was advanced to the debtor (the minority group alleged that the second tranche was held in escrow and never advanced); and d) it assumes that all new money was advanced up front—the second tranche of funds was to be made available only in July, which would reduce the effective duration of the loaned funds.

56 *See* Ad Hoc Equity Committee's Objection, *supra* note 53, at 8.

57 *See* DIP Hearing Transcript, *supra* note 31, at 153.

58 The percentage is derived by taking (900 – 53) / 900.

59 Given the 90/10 split from the credit bid, the first lien received value that is 1/9 of what the DIP lenders received, or $130 million. The roll-up converted $450 million of $2.021 billion of first lien debt into DIP loan debt that would have otherwise remained in place as first lien debt, so the majority's share of the first lien consideration should be deducted from the DIP loan payment.

60 *See* Order (I) Authorizing (A) Entry into and Performance Under the Asset Purchase Agreement and (B) the Sale of the OpCo Acquired Assets and the PropCo Acquired Assets Free and Clear of Liens, Claims, Encumbrances, and Interests, and (C) Assumption and Assignment of Executory Contracts and Unexpired Leases and (II) Granting Related Relief, at 79, *In re* J.C. Penney Co., No. 20-20182 (Bankr. S.D. Tex. Nov. 9, 2020), ECF No. 1814.

loan.[61] No court, to our knowledge, has ever approved a loan with such an exorbitant interest rate.

In *J.C. Penney*, as in many similar cases, the majority coalition possessed substantial market power at the DIP loan stage.[62] A major reason for this is the way section 364(d) operates procedurally. Because the majority group controlled the first lien class, they could consent to priming without a valuation fight over adequate protection. At the same time, the minority's priming lien proposal—despite its lower cost—was swiftly rejected by the debtor because, it argued, the time-consuming valuation fight risked destroying the company. These conditions made the majority group a de facto monopolist over the DIP loan.

Without a change to the Code, DIP lender monopoly power is unlikely to go away any time soon. But our calculation illustrates the benefits of standardization in making the true cost of a bundled DIP loan package transparent. If lenders want approval of a first-priority loan with a 545% interest rate, they should be forced to present this transparently to a court. We think judges would be much more likely to push back against extreme terms like these when the true cost is brought to light.

III. Asset-Liability Separation and Crossover Transactions

To a large extent, the law tries to keep asset-side and liability-side determinations separate from each other during a bankruptcy case. This modular separation of assets and liabilities serves a useful function. For a financially distressed firm operating outside of bankruptcy, liability-side issues, such as a looming maturity, can interfere with asset-side decisions in ways that are value-destroying. For example, a firm might choose to sell a valuable asset to avoid defaulting on a debt. Or it might be prevented from borrowing money that would increase overall firm value because it might trip a covenant and cause acceleration of debt. The automatic stay stops all collection activity, and payoffs

61 Annualizing a six-month rate "r" is done by compounding that rate using the formula $(1 + r)^2 - 1$.

62 During the early years of the Bankruptcy Code, it was typical for large corporate debtors to enter Chapter 11 with significant unencumbered assets. However, since the early 2000s, the practice of bankruptcy has shifted, with many firms entering bankruptcy with all of their assets encumbered by liens. As we noted earlier in footnote 13, the debt overhang problem exacerbates the difficulty faced by debtors in obtaining additional secured financing during bankruptcy, particularly without the prior consent of the pre-petition secured lender. These lenders, therefore, hold a significant bargaining power in the process, as proof of adequate protection is often expensive and time-consuming to produce.

to creditors are typically postponed to the plan of reorganization.[63] This simplifies management's problem substantially, allowing managers to focus exclusively on preserving asset value while the case proceeds with less interference from the liability side.

In addition to separating asset-side decisions from liability-side influences, the Code also provides different procedures and involves different sets of players for each side. Procedures governing pre-plan asset-side decisions are faster and more deferential to management. Chapter 11's debtor-in-possession model is founded on the belief that management continuity is necessary to preserve the value of a going concern.[64] The Code's procedural rules regarding assets also reflect the inherent time-sensitivity of asset-side decisions. In section 363, which governs the use, sale, or lease of assets, ordinary course asset decisions do not require notice to creditors or court approval;[65] non-ordinary course asset decisions do require notice and a hearing, but do not require creditor consent. Courts require a "good business reason" for approving a non-ordinary course asset sale,[66] but this standard is deferential to management's judgment in practice.

When it comes to liability-side decisions—determining the value and payoff on claims—the Code provides significantly stronger control rights to creditors and less deference to management.[67] This is sensible because management has little incentive or special expertise to defend priorities as between the classes of creditors. The plan settles the claims globally: A proper determination of priority as between any two parties must be able to compare the two parties' final treatment at a common point in time. Thus, the plan must involve the creditor body as a whole. As a result, complying with the Code's procedures on the liability side is necessarily more multilateral.

As a result, plan procedures intended to defend priorities can be time-consuming. Plan proponents must submit disclosure statements for approval by the court that provide information about the company and the plan of reorganization.[68] The plan requires a creditor vote backed by the Code's priority

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[63] 11 U.S.C. § 362(a).

[64] *See, e.g.*, H.R. REP. NO. 95-595, at 234 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6193–94.

[65] 11 U.S.C. § 363(c)(1).

[66] *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1069–72 (2d Cir. 1983).

[67] 11 U.S.C. § 1125 (requiring adequate information disclosure); 11 U.S.C. § 1126 (describing voting rules); 11 U.S.C. § 1129 (outlining plan-confirmation standards)

[68] 11 U.S.C. § 1125.

rules. A class voting against the plan is entitled to a judicial determination that the plan respects priority both vertically (as against senior and junior classes) and horizontally (as against classes of the same priority).[69] If a consensual plan is not available, then the debtor may require a contested valuation hearing to cram down the plan over a dissenting class.[70] Cramdown valuation hearings can be quite lengthy and costly, particularly when the capital structure is complex or the securities it distributes are harder to value.[71]

The costs and delays of this process are vices, not virtues, to be sure. All else equal, it is better to minimize them. But the chapter 11 process—by staying creditor collection, providing for new financing, and allowing for operations to continue running—is set up to provide a non-emergency setting where liability-side determinations can be made. The sub rosa DIP loan strategically undermines this setup by moving these determinations into the DIP loan process, a crossover transaction that is set up to accommodate time-sensitivity and management deference. The next section discusses the way bankruptcy law deals with these crossover transactions, uncovering standardization and unbundling as common regulatory approaches.

A. Crossover Transactions

Given the benefits of separating asset-side and liability-side decisions, we can see the challenge in regulating crossover transactions. How can the law simultaneously accommodate the time-sensitivity required on the asset side and the creditor protection required on the liability side?

The first place to start is to examine transactions that are inherently crossover transactions. If the debtor wants to acquire a new postpetition asset during the case using financing, it must provide some form of liability-side compensation to the asset provider. On these transactions, the law's general approach is to defer to the DIP's asset-side decisions, but limit the DIP's discretion regarding liability-side determinations. These limits serve the dual purpose of protecting asset value, while protecting the other creditors from debtor favoritism of the transaction parties due to distorted incentives, coercion, or indifference.

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[69] In addition to these class-based rights, there are priority-relevant protections for individual creditors. An individual creditor is entitled to receive at least as much as they would in a chapter 7 liquidation, and creditors within a class must receive equal treatment to other members of their class. *See* 11 U.S.C. § 1129(a)(7).

[70] 11 U.S.C. § 1129(b).

[71] The Iridium fraudulent transfer valuation dispute, for instance, required fifty days of trial. *See* Iridium Operating, LLC v. Motorola Inc. (*In re* Iridium Operating, LLC) 373 B.R. 283, 290 (Bankr. S.D.N.Y. 2007).

One limiting technique, mostly found in the structure of the Code, is standardizing the liability by restricting its form to a debt claim, and placing limits on its amount and priority ranking against the others. Standardization is a common technique for enabling comparison among items that may differ along many dimensions. By reducing the cost of gathering information, standardization can facilitate comparisons and promote competition.[72] Accounting principles serve this purpose, providing standardized metrics like net income that allow investors to compare one company's profitability to another.[73] In the bankruptcy context, standardization of DIP loans protects creditors by enabling competition and judicial scrutiny of the liability side in a way that is compatible with time-sensitivity.

A second technique, mostly created by courts, is unbundling; courts prevent the DIP from bundling unnecessary liability-side determinations into an asset-side decision.[74] Like standardization, unbundling is also a regulatory strategy used in other commercial contexts.[75] Antitrust law prevents a party holding a monopoly in one good from bundling or tying a related product to expand its market power to the second product.[76] In the bankruptcy context, DIP lenders possess significant market power over the DIP loan terms due to time sensitivity and the difficulty of priming secured creditors. They may leverage the power they possess at the DIP loan stage by bundling reorganization plan terms into the loan. Unbundling channels liability-side decisions into the plan of reorganization, where creditors have a stronger voice. It also permits greater competition for competing plans that might be proposed after the transaction. We discuss examples of standardization and unbundling strategies in turn.

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72 *See generally* Yoram Barzel, *Standards and the Form of Agreement*, 41 ECON. INQUIRY 1 (2004).

73 *See* Joseph H. Zhang, *Accounting Comparability, Audit Effort, and Audit Outcomes*, 35 CONTEMP. ACCT. RSCH. 245 (2018).

74 *See infra* Section III(A)(2).

75 The bundling strategy has been employed not just contractually and legally, but also in many instances technically. IBM, for example, has attempted to integrate its memory design with the system processor in order to block the access of non-IBM peripheral devices. For the use of bundling and unbundling strategy of IBM, see CARLISS Y. BALDWIN & KIM B. CLARK, DESIGN RULES: THE POWER OF MODULARITY (4th ed. 2000).

76 *See, e.g.*, Joseph Farrell & Philip J. Weiser, *Modularity, Vertical Integration, and Open Access Policies: Towards a Convergence of Antitrust and Regulation in the Internet Age*, 17 HARV. J.L. & TECH. 85 (2003).

1. Standardization Strategies

a. Executory Contracts

One example of the standardization strategy is section 365, which governs leases and executory contracts.[77] These contracts have, at time of bankruptcy, the features of assets and liabilities. To defend asset value, the Code gives the debtor time to decide whether the contract is a net asset or net liability to the estate. If it is a net asset, the debtor can assume it, and the assumption/rejection decision is left to the debtor's business judgment.[78] The liability-side effects, however, are standardized by the Code: Upon assumption, the future liability is given priority over the general unsecured creditors.[79] If the debtor rejects the contract, damages are treated as prepetition breaches, thus denying them administrative expense priority.[80] Most courts further limit the DIP's flexibility on the liability side through a threshold definition of executoriness known as the Countryman Test: If a contract is almost a pure liability (no material performance remains on the non-debtor's side of the contract), a court applying the Countryman Test would deem the contract non-executory.[81] This limits the DIP's freedom to assume a contract solely to elevate that liability's priority over the general creditors.

b. Administrative Expenses

The Code provides for claims associated with certain administrative expenses to receive priority over the general claims against the debtor.[82] This priority level has an asset-side motive: It encourages third parties to do business with the debtor despite its bankruptcy, which should ultimately benefit the

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77 *See generally* 11 U.S.C. § 365.

78 3 COLLIER ON BANKRUPTCY ¶ 365.03 (16th ed. 2023) ("Although the business judgment [test] is the proper standard for determining whether to permit assumption or rejection of an executory contract or unexpired lease, the court should focus on the business judgment of the trustee or debtor in possession, not on its own business judgment.").

79 Assumption makes any subsequent rejection a postpetition breach, entitling it to administrative expense priority status. *See* 11 U.S.C. § 365(g)(2).

80 A rejection becomes a prepetition breach, which denies it administrative expense status. *See* 11 U.S.C. § 365(g)(1).

81 *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 451–52 (1973) ("[The trustee's] assumption, on the other hand, would in no way benefit the estate and would only have the effect of converting the claim into a first priority expense of administration and thus of preferring it over all claims not assumed—a prerogative which the Bankruptcy Act has never been supposed to have vested in either the trustee or the court.").

82 11 U.S.C. § 503.

estate. Nevertheless, because the liability side is involved, the Code requires greater judicial scrutiny and less deference to management than it does for a pure asset-for-asset transaction.[83]

One class of claims receiving this status are those connected to "the actual, necessary costs and expenses of preserving the estate."[84] This includes, for example, employee wage claims for services performed during the case. To defend the interests of the general creditors, most courts require that the claim have arisen from a transaction with the bankruptcy estate and that the claim must have directly and substantially benefited the estate before affording it administrative expense status.[85] Thus, courts do not defer to the DIP's business judgment on the liability side in affording administrative expense priority. In the context of breakup fees for stalking horse bidders, for example, the Third Circuit explicitly rejected the management-deferential business judgment rule as a basis for determining whether administrative expense priority is warranted.[86] The court reinforced that the burden rests on the applicant to demonstrate that the fees were necessary to preserve the value of the estate. Similarly, in cases involving backstop fees, courts apply additional scrutiny beyond the business judgment test. In *In re LATAM Airlines*, for example, the court relied on expert witness testimony regarding comparable precedent transactions to conclude that the debtors satisfied the "actual" and "necessary" requirements in section 503(b).[87]

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83 *See supra* Section III(A).

84 11 U.S.C. § 503(b)(1)(A).

85 4 COLLIER ON BANKRUPTCY ¶ 503.04 (16th ed. 2023).

86 Calpine Corp. v. O'Brien Env't Energy, Inc. (*In re* O'Brien Env't Energy, Inc.), 181 F.3d 527, 535 (3d Cir. 1999) ("In other words, the allowability of break-up fees, like that of other administrative expenses, depends upon the requesting party's ability to show that the fees were actually necessary to preserve the value of the estate. Therefore, we conclude that the business judgment rule should not be applied as such in the bankruptcy context.").

87 *In re* LATAM Airlines Grp., No. 20-11254, 2022 WL 790414, at *29 (Bankr. S.D.N.Y. Mar. 15, 2022) ("However, at issue here is whether the Backstop Payment in the Commitment Creditors Backstop Agreement should be approved as 'actual, necessary costs and expenses of preserving the estates' under section 503(b)(1)(A) of the Bankruptcy Code. In doing so, the Court will consider whether the cost of the Backstop Agreements is reasonable."); *In re* Pac. Drilling S.A., No. 17-13193, 2018 WL 11435661, at *2 (Bankr. S.D.N.Y. Oct. 1, 2018) ("The Code allows for reasonable financing terms but they must be reasonable, and they cannot just be a disguised means of giving bigger creditors a preferential recovery. I therefore made clear that to the extent that these terms were being presented to me as reasonable financing terms, the parties would need to convince me that the terms were reasonable as a financing matter and were better than other options.").

c. DIP Loans

The most important example of standardization for our purposes is the provision for new financing under section 364. This involves both an asset and a liability decision, as the DIP loan provides new cash (the asset) but also creates a new liability (the DIP loan claim). Similar to its treatment of executory contracts, the Code leaves the asset-side decision (the amount of cash to raise) to the debtor's judgment, but it creates a set of standardized options for the priority ranking of the new liability through section 364's priority rules. In simplified terms, section 364 applies a balancing of asset-side and liability-side goals. As the DIP lender's priority demands increase, the Code provides greater creditor participation rights and a higher standard for approval.

Under section 364(a), a debtor can offer administrative expense priority—this makes the new liability senior to the general unsecured claims. To grant higher priority through a new lien or priority over other administrative expenses, the debtor must convince the court that the money could not have been raised through less aggressive protection of the DIP loan.[88] Courts play an important role in policing the interest rate and other loan terms by comparing the terms against precedent transactions and in ensuring that the debtor has appropriately market-tested the terms by canvassing the market for rival offers.

Despite section 364's priority scheme to standardize DIP loan compensation, judges have not yet applied this standardization mechanism to rule out rights offerings and other equity-linked securities as DIP loan compensation. Unbundling strategies have been much more common. We return to this issue in Section IV.

2. Unbundling Strategies

a. 363 Sales with Crossover Implications

As noted above, the DIP's business judgment is generally respected when crossover is not implicated. But courts push back significantly when the sale also determines payoffs to creditors and otherwise locks in liability-side effects.[89] In *In re Braniff Airways*, the court denied approval of a proposed sale of Braniff's assets to another airline. In addition to the sale, the debtor asked the court to

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[88] *See* Tung, *supra* note 10, at 668.

[89] *See*, *e.g.*, Pension Benefit Guaranty Corp. v. Braniff Airways, Inc. (*In re* Braniff Airways, Inc.), 700 F.2d 935, 940 (5th Cir. 1983).

bundle in features that would be otherwise left for the plan of reorganization. These included a requirement that part of the consideration in the form of travel scrip would be paid to certain parties, including the airline's former employees and shareholders. The transaction also locked up votes by requiring that secured creditor deficiency claims be voted in favor of any plan the unsecured creditors committee supported. The court saw this sale as an attempt to work around plan requirements and refused to authorize the sale under section 363(b).[90]

b. 9019 Settlements

Pre-plan settlements are governed by Bankruptcy Rule 9019. The rule provides little explicit guidelines to courts on an approval standard, however, stating only that courts may approve settlements "on motion by the trustee and after notice and a hearing."[91] Settlements allow the debtor to avoid costly litigation and the requirement of court approval adds transparency to the process, giving non-parties a chance to object to unfavorable deals.

In several cases, courts have wrestled with settlement proposals that have the potential to reduce costly litigation and improve the path toward reorganization, but also make distributions that may violate priorities. In these cases, courts have recognized the inherent tension between the asset-side and liability-side goals. The circuits that have considered the question have applied unbundling strategies of varying degrees of strength. In the *In re AWECO* case, the Fifth Circuit applied a per se rule to 9019 settlements, holding that courts may not approve any settlement that does not comply strictly with the absolute priority rule.[92] This is a stronger form of unbundling. It requires that the debtor postpone any potentially objectionable liability-side effects to the plan, irrespective of their asset-side benefits.

The Second Circuit applied a less stringent test in *In re Iridium Operating*, but also unbundled the transaction. It permitted a court to approve settlements that may deviate from priority by applying a multi-factor test, but held that a

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[90] *Id.* at 940 ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with a sale of assets.").

[91] FED R. BANKR. P. 9019.

[92] Internal Revenue Serv. v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 300 (5th Cir. 1984).

settlement's adherence to priority should be the most important factor in the analysis.[93]

In that case, the unsecured creditors committee of Iridium and its main lender, J.P. Morgan Chase, sought approval of a settlement of J.P. Morgan's disputed lien. The proceeds of the settlement would fund a trust to pursue other causes of action against Motorola, which held a priority unsecured claim. The court recognized the potential asset-side benefits of the settlement; by settling the litigation, the estate would save valuable cash and pursue a valuable asset in its Motorola cause of action.[94] But the court also earmarked a particular element of the settlement for unbundling. After the conclusion of the Motorola litigation, the trust sought to return excess funds to only the unsecured creditors. The court remanded to the bankruptcy court for justification of this priority-deviating element of the settlement that seemed to play no role in advancing the asset-side goals of the case.

c. DIP Loans

Courts have also applied unbundling strategies in the DIP loan context. One circuit court has held that cross-collateralization, whereby a DIP loan is used to also secure prepetition debt, is per se impermissible.[95] Roll-ups, whereby the proceeds of a secured DIP loan are used to pay off prepetition unsecured debt, are also disfavored, though not absolutely.[96] Courts typically consider roll-ups

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93 Motorola, Inc. v. Off. Comm. of Unsecured Creditors (*In re* Iridium Operating, LLC), 478 F.3d 452, 465–67 (2d Cir. 2007).

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> It is clear from the record why the Settlement distributes money from the Estate to the ILLLC. The alternative to settling with the Lenders—pursuing the challenge to the Lenders' liens—presented too much risk for the Estate, including the administrative creditors. If the Estate lost against the Lenders (after years of litigation and paying legal fees), the Estate would be devastated, all its cash and remaining assets liquidated, and the Lenders would still possess a lien over the Motorola Estate Action.

Id. at 465–66.

95 *See* Shapiro v. Saybrook Mfg. Co. (*In re* Saybrook Mfg. Co.), 963 F.2d 1490, 1494–96 (11th Cir. 1992).

96 *See* Final Order (I) Authorizing Debtors (A) to Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362,364(c)(1), 364(c)(2), 364(c)(3), 364(d)(1) and 364(e), (B) to Utilize Cash Collateral Pursuant to 11 U.S.C. § 363 and (c) to Purchase Certain Assets Pursuant to 11 U.S.C. § 363, and (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363 and 364, at 20, *In re* Lyondell Chem. Co., No. 09-10023 (Bankr. S.D.N.Y. Mar. 1, 2009).

to be extraordinary provisions that require special disclosure and special justification.[97]

As noted above, the DIP-RSA pairing has become a norm in the large chapter 11 case. In a few cases, however, courts have applied unbundling strategies to DIP loans that attempt to lock in reorganization plan consequences for the DIP lenders through an RSA or through the loan itself. These cases illustrate that unbundling is a matter of degree, and can take many forms. In some cases, courts have insisted on terms that weaken the tie between the DIP loan and the plan outcome without denying the transaction altogether;[98] in others, courts have denied the proposed transaction because of its plan-determining effects.[99]

Consistent with its treatment of other crossover transactions, courts do not defer to the debtor's business judgment regarding liability-side determinations. In particular, courts have applied unbundling strategies to DIP loan terms that attempt to leverage the bankruptcy process for the benefit of the DIP lender. In *In re Ames Department Stores*, the court approved a final DIP loan only after proposed terms that would give undue control to the lender had been removed.[100] Similarly, in *In re Belk Properties*, the bankruptcy court denied approval of a loan that sought to transfer control over the case to the secured lender and lock in a term sheet tied to the loan that would provide between 51% and 90% of the reorganized firm's equity to the secured lender.[101] In denying the motion, the court emphasized that approval of the DIP would make the reorganization plan a "fait accompli."[102]

More recently, the court in the *In re LATAM Airlines* case found a DIP loan to be a sub rosa plan. The controversial aspect of the DIP involved the most

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97 When prepetition secured debt is rolled into a DIP loan, it is typically secured and has administrative expense priority, so it cannot be subject to a cramdown.

98 *In re* Ames Dep't Stores, Inc., 115 B.R. 34, 40–41 (Bankr. S.D.N.Y. 1990); *In re* Belk Props., LLC, 421 B.R. 221, 223–26 (Bankr. N.D. Miss. 2009); Transcript of Hearing before the Honorable Craig T. Goldblatt, United States Bankruptcy Judge, at 143, *In re* TPC Grp., No. 22-10493 (Bankr. D. Del. Aug. 2, 2022), ECF No. 565 [hereinafter TPC Hearing Transcript].

99 *In re* LATAM Airlines Grp., 620 B.R. 722, 786 (Bankr. S.D.N.Y 2020); *In re* Chrysler, 405 B.R. 84, 113 (Bankr. S.D.N.Y. 2009).

100 *In re* Ames Dep't Stores, Inc., 115 B.R. 34, 40–41 (Bankr. S.D.N.Y. 1990) ("As originally structured, the proposed agreement with Chemical gave rise to concerns for whether the Chapter 11 process was being leveraged. It provided for default on the appointment of a trustee or examiner with enlarged powers under section 1104 of the Code. It contained no carve out for professional fees from the super-priority to be awarded to Chemical. It provided for default if the Court were to grant relief from the automatic stay at the request of any creditor owed in excess of $20 million . . . . At the final hearing, these clauses were modified.").

101 *In re* Belk Props., LLC, 421 B.R. 221, 223–26 (Bankr. N.D. Miss. 2009).

102 *Id.* at 226.

junior "Tranche C" facility, a $900 million loan tranche to be provided by a group of large shareholders, Qatar Airways Investments and Costa Verde Aeronautica S.A., who controlled 32% of the company's equity. The loan included a "Modified Equity Subscription" election, whereby the debtor could elect to convert the Tranche C loan into equity in the reorganized firm at a 20% discount to plan value. The case did not include an RSA, but the loan included RSA-like terms: covenants that made any other plan proposal an event of default under the DIP.[103]

The *LATAM Airlines* loan dispute shared many common elements with the *J.C. Penney* loan. The debtor also received a rival loan proposal from a group led by Knighthead, a holder of LATAM unsecured bonds, that claimed to offer better terms. As in *J.C. Penney*, the debtor focused on elements the Knighthead group could not offer as justification for approving the insider loan proposal.[104] One of these was the equity subscription plan itself, which they claimed gave the debtor important flexibility.

The court denied approval of the loan on the basis that the loan was a sub rosa plan. The equity subscription election, the court reasoned, would lock in future plan terms and short-circuit the plan review process.[105] Because the court had no way of knowing whether the 20% discount was appropriate at the DIP loan stage, it would not remove creditor or court control over future plan terms.

Other courts have taken more incremental actions to unbundle DIP loans from plan consequences. In the *In re TPC Group* case, a majority proposed a DIP loan that was tied to an RSA.[106] The RSA contemplated a plan whereby the company would raise $300 million in new equity to recapitalize the company. The RSA included several benefits available only to the majority group. One was a "direct allocation" of $135 million of the $300 million equity rights offering at a 35% discount to plan value. The RSA also provided a $36 million fee in the form of a "put option premium" to the majority group for backstopping the full $300 million amount. As with most DIP-RSA ties, failure to propose a plan consistent with the RSA would be a default under the loan. At the final DIP

[103] *In re* LATAM Airlines Grp., 620 B.R. 722, 814–15 (Bankr. S.D.N.Y 2020).

[104] *Id.* at 811 n.17.

[105] *Id.* at 819–20.

[106] Debtors' Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Senior Secured Priming Superpriority Postpetition Financing and (B) Use Cash Collateral, (II) Granting Liens and Providing Claims with Superpriority Administrative Expense Status, (III) Granting Adequate Protection to the Prepetition Secured Parties, (IV) Modifying the Automatic Stay, and (V) Granting Related Relief, at 13–36, *In re* TPC Grp., No. 22-10493 (Bankr. D. Del. Jun. 1, 2022), ECF No. 36.

hearing, the court approved the loan. But, concerned that loan approval would make alternative plans impossible, the court insisted on a clarification that a default on the DIP loan would not permit an exercise of remedies, such as seizing assets, without further approval.[107]

In the *In re SAS* case, Apollo, the DIP lender, sought approval of a DIP loan that included a call option, giving them the right to purchase equity in the plan at a predetermined plan value. The DIP loan also included "tag rights" that would allow Apollo to purchase up to 30% of the new money equity to be issued in the plan at the same terms available to a third party. These options could be terminated at the option of the debtor by paying Apollo a fee. The court ultimately approved the DIP because no party objected to it. Nevertheless, the court was troubled by the delegation of the termination option to the debtor only, with no input from the creditors. At its insistence, the parties agreed to modify the termination right so that the creditors would retain control rights over the termination decision during the plan process.[108]

IV. THE MISSING STANDARDIZATION SOLUTION

Though the courts in the *LATAM Airlines*, *TPC Group*, and *SAS* cases pushed back on plan-determining DIP loans using unbundling strategies, they have not yet relied upon the standardized nature of section 364 to reject the use of equity-linked securities as compensation for DIP loans. This issue has lurked in the background of these high-profile cases, and undoubtedly will be an important question in future ones. If DIP lenders can treat plan equity as a de facto interest payment on the DIP loan, it will create an easy end-run around plan provisions like section 1123(a)(4), which provides that creditors within a class receive equal treatment. If a majority group that provides a DIP loan can label any future plan

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> THE COURT: Right, but it is also the case that if your plan, essentially, or something substantially like it isn't confirmed after the DIP is approved then we're in a situation where we're in a default under the DIP, right. So it makes it awfully hard to confirm another plan if you exercise default remedies, right?
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> MR. HANSEN [counsel for the Ad Hoc Noteholder Group]: If you allow us to exercise default remedies at that point. If the debtor is unable to find alternative financing that you would approve over our objection to the extent we object, of course.
>
> THE COURT: Okay. So do you agree that even after I approve the DIP you don't get to enforce default remedies without further approval?

TPC Hearing Transcript, *supra* note 98, at 142–43.

108 *In re* SAS AB, 644 B.R. 267, 270–71 (Bankr. S.D.N.Y. Sept. 21, 2022).

payout as DIP loan compensation, the equal treatment provision would be circumvented.

Below, we discuss several cases that touch upon but do not resolve this important issue. In several of them, courts note the difficulty in valuing future plan payoffs, thus making it harder to defend the interests of the other creditors. This is exactly the problem that a standardization strategy is well placed to address.

A. In re LATAM Airlines

The *LATAM Airlines* case was the first to directly confront the issue. To defend against the objecting creditors' sub rosa plan argument, the debtor suggested that their plan equity was DIP loan compensation. To address this argument, the court distinguished the circumstances of *LATAM Airlines* from those of *In re Chrysler*, where the government's investment in New Chrysler was repaid in part through equity interests in the New Chrysler entity.[109] The court noted that the Chrysler equity had no bearing on the Old Chrysler estate's creditors: "[A] determination now that the Debtors are free to allocate the reorganized equity to their shareholders (and at a 20% discount to some of them) is relevant to the estate's economic interests generally, and specifically to the rights of all estate creditors under the plan process."[110]

Though the distinction with *Chrysler* may be valid, it also proves too much. Every DIP loan obligation, even a plain-vanilla debt claim, is a crossover transaction. As such, it necessarily affects the rights of the estate's other creditors in the eventual plan. DIP loans are almost always secured and have administrative expense priority. As such, the DIP loan must be paid before the estate's other creditors, which necessarily affects their economic interests.

The court makes a more important distinction elsewhere in the opinion, noting that it would be infeasible to value the discounted equity to determine the value of the loan payoff on the other creditors due to time constraints.[111] This is exactly why the standardization mechanism in section 364 is essential: It allows

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[109] *In re* LATAM Airlines Grp., 620 B.R. 722, 817 (Bankr. S.D.N.Y. 2020); *In re* Chrysler, 405 B.R. 84, 92 (Bankr. S.D.N.Y. 2009).

[110] *In re* LATAM Airlines Grp., 620 B.R. 722, 817 (Bankr. S.D.N.Y. 2020).

[111] *Id.* at 820 n.120 ("Here, there is no evidence regarding the Debtors' enterprise value, and such a valuation analysis is simply not possible at this stage of the bankruptcy. Thus, there is no record upon which the Court can determine what value or assets, if any, is left for distribution to other creditors of the LATAM estates.").

for court evaluation of the terms in a way that is compatible with the time-sensitivity required for DIP loan approval.

B. In re TPC Group

In *TPC Group*, the court also expressed concern about the future implications of the RSA deal on the plan, suggesting that the DIP-RSA structure implements a plan structure that treats similarly situated creditors unequally. In passing, however, the court noted that the ad hoc group's compensation might have been characterized as compensation on the DIP loan:

> During the cross-examination of Mr. Jamal, there was evidence that the members of the ad hoc group would under the plan receive substantial value that is not described as a payment on account of their prepetition secured claim *or payment under the DIP*, but is instead essentially described as fees for backstopping the rights offering and the exit facility. And on hearing that testimony, it really jumped out and underscored that this question of whether that value is on account of the prepetition debt or on account of those plan transactions will be important to whether the plan comports with the requirement of the Bankruptcy Code that similarly-situated creditors be treated alike . . . . And I've got some concerns that these transactions here aren't market tested, which, if right, would counsel in favor of the view that it's actually consideration being given on account of the claims, which would give rise to claims of discriminatory treatment.[112]

The passage highlights the interconnectedness of DIP loan compensation and the plan protections for creditors nominally uninvolved in the DIP loan. If parties *can* argue that equity is allowable payment on the DIP loan, then market testing and other checks on unfair treatment would have little bite.

C. In re SAS

In the *SAS* case, the court approved Apollo's DIP loan because no party objected to it. But it issued a strongly-worded rebuke of the loan's terms with the clear intent of discouraging future equity-linked DIP loans. The court noted the difficulty of valuing Apollo's option compensation at the beginning of the case:

> But in this particular case, call option valuations would have to be based on a calculation of the current total enterprise value of the

[112] TPC Hearing Transcript, *supra* note 98, at 188–89 (emphasis added).

> Debtors (which is itself not so easy to calculate given that the Debtors are in the midst of an ambitious cost-reduction plan) and based on the expected "volatility" as to what the total enterprise values might turn out to be in the future. In fact, we have no idea what the future enterprise value will be; we do not know what cost savings are going to be achieved, we do not know what else is going to happen in the markets between today and the date on which the enterprise value will be calculated, and we do not know, other than by pure guesswork, exactly how to figure what the volatility is.[113]

The debtor's advisors presented estimates of the cost of these rights, but the court believed the advisors' intent was to underestimate their cost in order to secure approval.[114] Most importantly, the court inferred that these rights were likely to be more valuable than the debtor suggested, given how hard Apollo bargained to get them.[115]

We believe the court was right to make this inference. In classic corporate finance theory, firms have superior information to their investors about the values of securities they issue. In that environment, the decision to issue information-sensitive securities, like equity, in lieu of debt, serves as a signal that those securities are "lemons" (i.e., overvalued). The modern DIP loan environment is the lemons problem in reverse. DIP lenders are most likely to propose more informationally-sensitive equity securities for court approval exactly when those securities are likely to be gems (i.e., undervalued). Standardization of DIP loan compensation is an important check on this problem.

V. THE CASE FOR DEFENDING PRIORITY: A REASSESSMENT

Bankruptcies like J.C. Penney's demonstrate how the "secure" has been taken out of secured debt. Asset-side goals trump liability-side goals. But why is defending priority as between creditors all that important? In simple terms, priority shifts in cases like *J.C. Penney* undermine capital structure commitment. Law and economics scholars typically assume that firms make their capital

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113 *In re* SAS AB, 644 B.R. 267, 274 (Bankr. S.D.N.Y. 2022).

114 *See id.* at 275 ("I do not mean to be overly critical of the advisors, but these calculations give me the impression that they were selected more for the purpose of trying to downplay the likely costs of the tag right termination fees, rather than for the purpose of showing what the likely costs will be.").

115 *See id.* at 274–75 ("I also do not have a clear sense at all of how to value the tag rights. The tag rights do not involve options to buy at any particular price; instead, they are rights to buy at the prices that are available to third parties. Apollo bargained very hard to get them, and it bargained hard for the inclusion of relatively high termination fees, so the bargaining history clearly tells me that these are very valuable rights.").

structure choices with intention: capital structure decisions can solve incentive and information problems that can increase the value of healthy companies.[116] In the new world of "bankruptcy hardball,"[117] it is impossible to assure any secured creditor—particularly a less active one—that their seniority will be respected. There are several potential costs of these strategic priority shifts that raise efficiency concerns about the bankruptcy system.

The first set of costs are ex ante costs. One of the important benefits of secured credit is its information insensitivity. An uninformed creditor will know less about the company than its managers. In such an environment, adverse selection or "lemons" problems can cause credit rationing, whereby valuable projects are denied funding.[118] The academic literature notes that collateral can be an important way around the credit rationing problem, allowing lenders to screen out better quality firms by requiring collateral. If firms can't make this commitment credibly, it may result in credit rationing and lower ex-ante investment by healthy firms.

A crucial development in modern finance is the rise of securitized term loan debt. Over 70% of new leveraged loan issuances are bought by CLOs.[119] Anecdotally, CLOs are often the victims of priority-shifting tactics. Patrick Bolton and Xavier Freixas have explained why it is valuable to have this kind of senior, securitized debt in the capital structure.[120] In their model, bank loans are easier to renegotiate in distress than bonds; hence, there is a value to having bank debt in the capital structure. But bank capital is also more expensive due to the cost of intermediation. Bond debt could be used to avoid this intermediation cost, but because it is junior in priority to banks, the presence of bond debt gives banks excess incentive to liquidate good firms in financial distress. Replacing some bond debt with securitized senior debt can avoid this liquidation problem while avoiding some intermediation costs of bank finance. Bolton and Freixas's model shows why the inability to guarantee a senior position for securitized debt will increase companies' cost of capital by undermining the incentive schemes built into capital structures.

116 *See* Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy*, 72 WASH. U. L.Q. 1213 (1994); Douglas G. Baird, Three Faces of Creditor-on-Creditor Aggression (Feb. 10, 2023) (unpublished manuscript) (on file with authors).

117 The term is from Jared A. Ellias & Robert J. Stark, *Bankruptcy Hardball*, 108 CAL. L. REV. 745 (2020).

118 *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981).

119 A collateralized loan obligation (CLO) is a single security backed by a pool of diversified debt.

120 Patrick Bolton & Xavier Freixas, *Equity, Bonds, and Bank Debt: Capital Structure and Financial Market Equilibrium Under Asymmetric Information.* 108 J. POL. ECON. 324, 325 (2000).

Ex post, there are several costs associated with priority shifting, even within the creditor body. The first is the possibility of socially wasteful rent-seeking.[121] Sophisticated creditors increasingly rely on sophisticated professionals to devise offensive strategies for redistributing value, and defensive strategies for preventing them. In the modern case, we should expect these professional costs to grow, and ultimately to be passed on to borrowers through higher costs of capital.

The second ex post cost is distorted incentives. One of these is the forum shopping decision. Should bankruptcy favor a subset of creditors over others, it increases the incentive of the potential winners to seek out bankruptcy even if the filing is unnecessary. For example, J.C. Penney entered bankruptcy with over $500 million in cash, and several parties questioned whether a bankruptcy filing was necessary given the company's ample liquidity.[122] Given that bankruptcy provides more powerful tools for effecting priority shifts, a weakening of priorities can enable strategic, unnecessary bankruptcy filings.

There are costs of distorted incentives within a case as well. When transactions are driven by priority-shifting motives, they frequently involve workarounds of constraints in law and contract. Capital structure changes that result from these workarounds can be suboptimal, and generate unintended efficiency consequences as a result.[123] In *J.C. Penney*, for example, priority extraction was achieved by placing the majority ahead of the minority and taking control over the case. Thus, the capital structure morphed from a pro-rata first lien structure to a senior/junior structure with senior creditors having full control of the case through the RSA. Bankruptcy theory and evidence suggest that senior lenders have greater incentives to end the case quickly to protect the value of their senior claim.[124] Some creditors openly speculated that the multi-tranche DIP loan, and the RSA giving the lender's business plan approval rights, was a

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121 *See* Roe & Tung, *supra* note 23, at 1236–37.

122 Cathy Hershcopf, counsel for the Unsecured Creditors' Committee, at the DIP hearing:

> Your Honor, J.C. Penney entered this case with $450 million in cash, and up to a billion dollars of unencumbered real estate. Given those fact that separate this retailer from almost every other retailer with whom I've worked in the past decade, some ask why J.C. Penney actually needed to file Chapter 11 now. But those are questions for another day.

DIP Hearing Transcript, *supra* note 31, at 24.

123 Kenneth Ayotte & Christina Scully, *J. Crew, Nine West, and the Complexities of Financial Distress*, 131 YALE L.J.F. 363, 363–66 (2021).

124 Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 511–13 (2009).

ruse intended to allow the lenders to liquidate the company's valuable real estate.[125] J.C. Penney ultimately survived, but similar distortions might cause the liquidation of a viable company.

CONCLUSION

Chapter 11 is reaching a crossroads. Should bankruptcy law become a "golden ticket" mechanism, allowing the debtor's chosen DIP lender coalition to determine plan payoffs? Or should it make a serious attempt to defend the priority structure inherent in reorganization plan rules? Finding the right answer to this question is not as easy as it seems. Modern DIP loans tied to RSAs do indeed serve important asset-side goals: They eliminate costly conflict and provide a certain and quick path to exit. Proponents will argue that DIP loan approval may be the difference between survival and liquidation. Many such threats are purely strategic, but some may be real. The investors who win the golden ticket in one case will lose the next time around; random wins and losses among investors will simply wash out ex ante in the interest rates creditors require. Golden ticket bankruptcy seems like the easier path to pursue.

We argue, instead, that the more difficult path is the right one. Priority protection remains a crucial feature of chapter 11. It allows companies to commit to capital structures that increase value for healthy firms. And it prevents dangerous distortions, like forum shopping, that would result in parties using or avoiding chapter 11 strategically. Judges must make difficult judgment calls to prevent DIP loans from becoming an easy workaround of reorganization plan provisions.

The sub rosa DIP loan problem is characteristic of all pre-plan crossover transactions that involve the asset- and liability-sides of the balance sheet. The law uses two strategies the to govern these crossover transactions: standardization and unbundling. Courts have begun to use unbundling strategies to prevent DIP loans from locking down plan payoffs. But they have not yet used the standardization mechanism in section 364 from preventing equity-linked repayment of DIP loans. This is an important next step.

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[125] *See* Crossholder Group Objection, *supra* note 30, at 3 ("At best, the RSA is an agreement to agree, but, like the second tranche of the proposed DIP financing, is illusory and overridden by the quick trigger that its signatories can pull to force the Debtors into a full-scale liquidation.").