CRACKING THE CODE: THE LEGAL AUTHORITY BEHIND EXTRASTATUTORY DEBTOR-IN-POSSESSION FINANCING MECHANISMS AND THEIR PROSPECTS FOR SURVIVAL

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I. INTRODUCTION

In surveying the landscape of bankruptcy law twenty-five years after its dramatic renovation in 1978, Professor Douglas Baird has observed the gradual development of numerous practices in debtor-in-possession ("DIP") financing that do not accord with the plain meaning of the text of the Bankruptcy Code (the "Code"), yet "have become deeply engrained and will remain a part of bankruptcy practice as long as no one objects."[1] However, when someone *does* object, appellate judges, expressing "little sympathy for interpretations of the Bankruptcy Code that are out of step with what seems the plain language of the statute," have sometimes stricken such procedures, despite their common acceptance among bankruptcy specialists.[2] By examining three practices that lack explicit statutory approval, this survey piece seeks to evaluate not only their legal and normative validity, but also the ability of strict constructionist judges to curtail them in opposition to the will of most practitioners and DIP lenders.

Part II discusses cross-collateralization, which the Eleventh Circuit Court of Appeals invalidated in *Shapiro v. Saybrook Manufacturing Co. (In re Saybrook Manufacturing Co.)* over one decade ago, in spite of the overt approval of numerous bankruptcy courts.[3] Because cross-collateralization enables a lender to guarantee primacy in reimbursement for any previously unsecured claims that arose before the filing of the debtor's bankruptcy petition, it controverts the Section 507 priority scheme for payment of unsecured creditors in liquidation. Nonetheless, many practitioners have criticized *Saybrook* for attempting to undo a practice that fulfilled the general Chapter 11 purpose of debtor rehabilitation by offering troubled businesses access to cash necessary to maintain their operations. This

[1] Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 97 (2004).

[2] *Id.* at 95.

[3] 963 F.2d 1490 (11th Cir. 1992).

prevalent sentiment has fueled the survival of cross-collateralization, despite the Eleventh Circuit's genuine effort to uphold the plain meaning of the text of the Bankruptcy Code. Even though most potential DIP financers possess multiple reasons to extend credit to a debtor anyway, bankruptcy courts outside the Eleventh Circuit have continued to oblige their demands for cross-collateralization and similar "rollup" provisions as incentives to lend.

Part III addresses critical vendor orders, which bankruptcy judges have regularly granted to induce favored suppliers to extend favorable credit terms to a debtor in bankruptcy in return for immediate reimbursement on their unsecured claims. In 2004, the Seventh Circuit Court of Appeals announced its disapproval for critical payments in the case of *In re Kmart Corp.*, once again because of their absence from the Bankruptcy Code.[4] Yet, informed by the Eleventh Circuit's failure to stamp out cross-collateralization, this survey piece suggests that many bankruptcy courts will persist in issuing critical vendor orders despite the *Kmart* decision. Convinced of their important role in restoring businesses to fiscal solvency, practitioners may now invoke a statutory argument posited by *Kmart* in dicta that might convince even the most textual interpreters of critical payments' legality. Moreover, just as practitioners still seek cross-collateralization orders outside the Eleventh Circuit, they may respond to trade creditors' demands for supply incentives by filing bankruptcy petitions in favorable jurisdictions, such as the Southern District of New York and the Third Circuit (including the District of Delaware), where case law has consistently defended critical payments as necessary prerequisites for debtor rehabilitation in Chapter 11.

Part IV discusses a subject that the courts have not yet tackled: restrictive loan covenants that empower a DIP financer to exercise control over the governance of an insolvent debtor. Notable academics have primarily argued

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[4] 359 F.3d 866 (7th Cir. 2004), *cert. denied*, 125 S.Ct. 495 (2004).

that such provisions encourage overly cautious DIP financers, anxious to recoup their investments, to trigger economically suboptimal liquidations of businesses that could otherwise survive reorganization. As a general principle, this article urges the judiciary not to interfere with the freedom of commercial lenders and debtors to contract for the terms of their loan agreements. Whereas cross-collateralization and critical vendor orders impermissibly shrink the size of the pool of assets available to general unsecured creditors in liquidation, governance provisions do not similarly violate the text of the Bankruptcy Code. Moreover, the history of cross-collateralization, in tandem with the likely persistence of critical vendor payments after *Kmart*, counsels that judicial efforts to invalidate common conditions of DIP financing contracts shall prove ineffective. Rather, they shall simply embolden lenders to renovate their strategies for gaining control over a weary debtor's operations. Nonetheless, any such license must exist with limitation. Thus, this paper will also recognize lender activities which may be so abusive as to require invalidation by the court.

II. CROSS-COLLATERALIZATION

In regulating the affairs of insolvent businesses, the rules governing Chapter 11 reorganization serve two vital functions. Not only do they provide a debtor an opportunity to repair its fiscal health, but also they ensure a fair and equitable distribution of the debtor's assets to its various creditors.[5] To achieve the first of these goals, Chapter 11 permits a business, under the direction of its DIP, to obtain from outside lenders the financing necessary to continue its operations during bankruptcy.[6] Often, in its effort to solidify support for the business' future success, a DIP requests such

[5] *See* DAVID G. EPSTEIN, BANKRUPTCY AND RELATED LAW IN A NUTSHELL 403-05 (6th ed. 2002); Brian Leepson, Note, *A Case for the Use of a Broad Court Equity Power to Facilitate Chapter 11 Reorganization*, 12 BANKR. DEV. J. 775, 799 (1996).

[6] *See* 11 U.S.C. § 364 (2000).

financing from the very creditors who possess claims in the bankruptcy estate.[7] However, Chapter 11 does not prevent a preexisting creditor from rejecting the DIP's overture to enter into a new financing agreement. For this reason, creditors wield significant leverage in attaining concessions from a DIP desperate to procure the monetary resources that the business requires to meet its expenses.

Cross-collateralization, or the practice by which a DIP agrees to grant a lien on certain collateral to secure its prior or later debt to a lender, represents one such concession that a creditor may demand from a DIP. Insofar as it convinces a nervous creditor to lend, cross-collateralization promotes the rehabilitation of insolvent businesses, so that they might eventually emerge from bankruptcy with a fresh start. However, cross-collateralization also empowers an undersecured creditor-lender to claim a greater portion of a business' assets than it would ordinarily receive under the repayment rules established in the statutory text of the Bankruptcy Code. On account of these simultaneous benefits and detriments to the achievement of the dual functions of reorganization, some courts have endorsed cross-collateralization for its innovation, while others have decried it for contravening the plain meaning of the Code. Yet, even though some judicial districts and circuits banned cross-collateralization altogether over a decade ago, skillful practitioners have adapted by shopping for forums that still approve of the practice, and by developing new "rollup" strategies that retain many of the benefits that cross-collateralization has offered to debtors in their attempts to return to solvency.

[7] *See* John D. Ayer et al., *Obtaining DIP Financing and Using Cash Collateral*, 23-SEP AM. BANKR. INST. J. 16 (2004). A possible explanation may be the desire to avoid some of the financing costs, such as facility fees, that a new lender might seek to impose. *See* Scott D. Cousins, *Postpetition Financing of Dot-Coms*, 27 DEL. J. CORP. L. 759, 760-61 (2002).

A. Cross-Collateralization Defined

As the grant of a lien on post-petition collateral to secure pre-petition debt, cross-collateralization has generated great controversy for enabling lenders to transform their previously undersecured claims against a DIP into secured debt for which they must receive full payment. Pursuant to the Bankruptcy Code, a creditor's allowed claim in an estate's collateral in which he possesses a security interest is secured only to the extent of the value of the collateral at the time of the debtor's filing of the bankruptcy petition.[8] As an illustration of the significance of this rule, assume that a bank lends $30,000 to a solvent debtor, and subsequently takes a security interest of equivalent value in its collateral. In the months that follow, however, not only does the debtor encounter great financial hardship, but also the value of the collateral depreciates. If the collateral maintains a value of just $20,000 on the date of the debtor's filing for bankruptcy, the bank has generally become undersecured; it does not possess a secured claim for $30,000 against the collateral,[9] but rather a secured claim for $20,000 and an unsecured claim for the $10,000 in value that the collateral had lost. Consequently, in the event that reorganization fails and the debtor must liquidate its assets, although it can receive full compensation for its secured claim of $20,000, the bank, along with the debtor's many other general unsecured creditors, will receive only a pro rata distribution with respect to the unsecured portion of its claim.[10]

Cross-collateralization enables the bank and other undersecured creditors to avoid this circumstance by securitizing fully their pre-petition claims. In return for a creditor's agreement to finance the debtor's operations in

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[8] *See* 11 U.S.C. § 506(a) (2000).

[9] Under certain circumstances, however, a secured creditor may elect treatment under 11 U.S.C. § 1111(b) (2000). This section provides that when such an election is permitted, then notwithstanding Section 506(a), the undersecured claim will be treated as a secured claim to the extent that such claim is allowed.

[10] *See* 4 COLLIER ON BANKRUPTCY § 506.03[4] (Rev. 15th ed. 2004).

bankruptcy, the debtor grants the creditor a security interest in its post-petition assets to secure the undersecured portion of the creditor's pre-petition claim.[11] Via cross-collateralization, the bank in the above example could obtain additional security valued at $10,000 in the debtor's assets, and thereby once again hold a $30,000 secured claim. As a result, in the event of liquidation, the bank can recoup not $20,000, but rather $30,000 before any priority claimants or general unsecured creditors receive a single dime from the bankrupt estate.

Indeed, cross-collateralization represents a win-win situation for a DIP and his undersecured lender-creditor: The DIP obtains necessary financing to run his business, while the lender-creditor rehabilitates the value of his prior investment. However, according to detractors of cross-collateralization, it cheats other unsecured creditors out of an opportunity to share fairly and equitably in the proceeds of a possible future liquidation. In particular, cross-collateralization applies previously unencumbered assets of the bankrupt estate to secure pre-petition debt, and renders those assets unavailable "for pro rata distribution on all unsecured claims."[12] Thus, "[u]nsecured creditors who otherwise would share *pari passu* with a pre-petition lender on account of its unsecured deficiency claim, are deprived of the assets which secure such claim."[13] In this way, cross-collateralization, though not explicitly mentioned by name in

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[11] *See* Michael L. Cook & Jeffrey S. Sabin, *Business Reorganization—2004*, 863 PLI/COMM 31, 51 (2004).

[12] Karen M. Gebbia & Lawrence E. Oscar, *Saybrook Manufacturing: Is Cross-collateralization Moot?*, 2 J. BANKR. L. & PRAC. 163, 202 (1993).

[13] Daniel M. Glosband et al., *Current Developments on the Automatic Stay, Post-petition Lending and the Use of Section 105*, 379 PLI/REAL 237, 299 (1992). This result does not arise if the creditor's pre-petition claims are fully secured at the time that it lends to the DIP. In such a case, cross-collateralization would merely oversecure the lender's debt. At the time of liquidation, the bankruptcy trustee could reapply the excess secured collateral to the estate for general unsecured creditors to share. *See* Gebbia & Oscar, *supra* note 12, at 185; *see also In re* FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985).

the Bankruptcy Code, undermines the Code's goal to offer "similar treatment for similarly situated creditors."[14]

In response, supporters dismiss concerns about equality of unsecured creditors as outweighed by the vital role that cross-collateralization can play in starting an insolvent business along a path toward eventual prosperity. Obviously, lending to a bankrupt estate with a track record of fiscal failure constitutes a prodigious risk for many investors. Therefore, pre-petition creditors need the benefits of cross-collateralization as an incentive for lending anew post-petition.[15] For this reason, regardless of the Code's specific limitations on priority of payment to unsecured creditors in liquidation, proponents view cross-collateralization as an example of a "necessary [and] appropriate" method endorsed by the Bankruptcy Code as a means for sustaining a debtor business as it reorganizes.[16] Against the backdrop of this ongoing debate, bankruptcy and appellate courts have considered the legal and normative arguments for and against cross-collateralization.

B. The Development of the Law of Cross-Collateralization

In 1979, the Second Circuit Court of Appeals issued the first significant judicial opinion to address the merits of cross-collateralization. *Otte v. Manufacturers Hanover Commercial Corp. (In re Texlon Corp.)*,[17] discussed the propriety of an order issued ex parte by a bankruptcy judge to permit a financing bank to secure its pre-petition loans to Texlon with Texlon's post-petition collateral. Although Judge Henry Friendly criticized cross-collateralization as "contrary to the spirit of the [pre-1979] Bankruptcy Act" for

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[14] *See* Glosband, *supra* note 13, at 299; Gebbia & Oscar, *supra* note 12, at 202.

[15] *See* Donald A. Jordan, Note, *Cross-collateralization in Chapter 11: Protecting the Small Business*, 40 WAYNE L. REV. 219, 231-32 (1993).

[16] *See* 11 U.S.C. § 105(a) (2000); *see also* David B. Young, *Preferences and Fraudulent Transfers*, 804 PLI/COMM 577, 676 (2000).

[17] 596 F.2d 1092 (2d Cir. 1979).

its role in disqualifying assets from later equitable distribution to unsecured creditors, he refused "to say that under no conceivable circumstances could 'cross-collateralization' be authorized."[18] Rather, the Second Circuit limited its decision to hold that a bankruptcy judge could not approve a cross-collateralization order ex parte.[19] Such an order could stand only if other creditors received notice of the order, and subsequently could be heard on any objections.[20]

Mindful of the Second Circuit's opposition to the specific financing order presented in *Texlon*, yet also aware of the significant incentives that cross-collateralization offered to potential DIP financers, the Bankruptcy Court for the Eastern District of New York established a test for evaluating cross-collateralization orders based upon their utility and their necessity. This four-part rubric, announced in the case of *In re Vanguard Diversified, Inc.*,[21] imposed a high burden on DIPs to demonstrate so great a need for financing as to justify the cross-collateralization order, in spite of the preferential treatment that the lender would enjoy as a result:

> In seeking to grant cross-collateralization, the debtor-in-possession must demonstrate that: (1) Absent the proposed financing, its business operations will not survive . . . ; (2) It is unable to obtain alternative financing on acceptable terms . . . ; (3) The proposed lender will not accede to less preferential terms; and (4) The proposed financing is in the best interest of the general creditor body.[22]

By this test, the *Vanguard* court aimed not to condone every proposal for cross-collateralization, but rather to establish guidelines for its use as a tool to provide truly desperate businesses the opportunity to continue their

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[18] *Id.* at 1098.

[19] *See id.*

[20] *See* Gebbia & Oscar, *supra* note 12, at 190.

[21] 31 B.R. 364 (Bankr. E.D.N.Y. 1983).

[22] *Id.* at 366.

operations. For example, as bankruptcy court testimony revealed, Vanguard lacked sufficient cash to pay employee salaries and numerous other expenses.[23] Although Vanguard issued numerous inquiries to possible lenders, one creditor bank agreed to offer financing, but only upon receiving a security interest in post-petition collateral to back its pre-petition claims.[24] Despite the absence of any formal mention of cross-collateralization in the Bankruptcy Code, the court acknowledged the stark reality that Vanguard "would in all likelihood cease operating and be forced to liquidate" without necessary financing.[25] In the event of liquidation, not only would Vanguard's assets lose much of their going-concern value, but Vanguard's unsecured creditors would recoup much less on their investments (perhaps nothing at all) than they would if Vanguard could emerge successfully from reorganization.[26] For these reasons, the court dismissed the formal legal obstacles to cross-collateralization and approved the order to boost the fortunes of Vanguard and its many creditors.

In the wake of the holding in *Vanguard*, a number of bankruptcy courts, particularly in the Second Circuit, adopted its four-part test.[27] Indeed, as the 1980's progressed, creditor-lenders, emboldened by *Texlon*'s equivocation, more and more often requested and received cross-collateralization

[23] *See* Gebbia & Oscar, *supra* note 12, at 210.

[24] *See Vanguard*, 31 B.R. at 366. The fact that no one else would lend to Vanguard is particularly indicative of the need for cross-collateralization. New investors will assess their investment in terms of expectations for future returns. The lack of any willing new investor shows that those expectations are insufficient to justify the extension of credit. An existing creditor, however, may further justify the extension of post-petition credit, by reason of any enhancement in the collectability of its pre-petition indebtedness.

[25] *Id.* at 367.

[26] *See id.*

[27] *See, e.g.*, *In re* Roblin Indus., Inc., 52 B.R. 241, 244 (Bankr. W.D.N.Y. 1985); *In re* Antico Mfg. Co., 31 B.R. 103, 105 (Bankr. E.D.N.Y. 1983).

orders in large Chapter 11 cases.[28] A high point for acceptance of cross-collateralization came in 1987, when the Sixth and the Ninth Circuits ruled that the reversal of a cross-collateralization order could not impact the validity of credit granted under it.[29] As authority for this holding, both circuits cited Section 364 of the Bankruptcy Code, which establishes procedures by which a business may obtain credit for the purpose of sustaining its operations. In particular, pursuant to the "mootness doctrine" of Section 364(e), the reversal or modification of a financing order provided "*under this section*" cannot affect any liens, debts, or priorities created thereby in the absence of a stay pending appeal, so long as the lender extended financing in good faith.[30] Because Section 364 does not provide for cross-collateralization as a permissible financing scheme, parties to the cases in both circuits contended that an extension of credit under a cross-collateralization order could be properly voided regardless of the presence of a stay. However, the Sixth and the Ninth Circuits rejected this argument, despite the Code's silence concerning the propriety of cross-collateralization. Acknowledging that "cross-

[28] *See* Charles Jordan Tabb, *Requiem for Cross-collateralization?*, 2 J. BANKR. L. & PRAC. 109, 109-10 (1993); *see also* Jason B. Burnett & Kenneth B. Jacobs, *Cross-collateralization in the Wake of* Shapiro v. Saybrook Manufacturing Co. (*In re* Saybrook Manufacturing Co.), 9 BANKR. DEV. J. 503, 512 (1993).

[29] *See* Burchinal v. Central Wash. Bank (*In re* Adams Apple, Inc.), 829 F.2d 1484 (9th Cir. 1987); Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co. of Escanaba (*In re* Ellingsen McLean Oil Co.), 834 F.2d 599, 604 (6th Cir. 1987).

[30] 11 U.S.C. § 364(e) (2000) (emphasis added), which reads in full:

> The reversal or modification of an appeal under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

collateralization clauses are not expressly included in the list" of approved financing mechanisms under Section 364, the Ninth Circuit nonetheless resolved that cross-collateralization satisfied Congress' "overall policy . . . to provide a debtor a means to obtain credit after filing bankruptcy," and hence enjoyed Section 364(e) protection.[31] Meanwhile, the Sixth Circuit applied the mootness doctrine to cross-collateralization orders "[i]n the absence of any case law clearly indicating that section 364(e) cannot extend" to them.[32] By these precedents, on account of Section 364(e), even if a district or appellate court concluded that a cross-collateralization order failed to pass the *Vanguard* test, that court lacked the power to undo the pertinent financing agreement that the lower bankruptcy court had approved. As a consequence, non-lending creditors could win merely a moral victory in successfully appealing a cross-collateralization order, while the lender retained his interest in the debtor's post-petition collateral to secure fully his pre-petition claims.

C. *Saybrook*: The Tide Turns Against Cross-Collateralization

During the course of the 1980's, cross-collateralization of pre-petition debt had evolved from a legally suspect method of financing in *Texlon* to a condition that creditors regularly demanded before lending to a debtor in possession. Once appellate courts decided to invoke the mootness doctrine to preserve cross-collateralization orders, disfavored unsecured creditors lacked much incentive to protest their validity.[33] So long as unsecured creditors simply accepted it as a commonplace aspect of DIP financing, cross-collateralization would continue to flourish, regardless of its role in reducing their shares in the bankruptcy estate in the event of liquidation.

[31] *Adams Apple*, 829 F.2d at 1488.

[32] *Ellingsen MacLean*, 834 F.2d at 604.

[33] *See generally* Gerald F. Munitz, *Obtaining Credit*, 796 PLI/COMM 267, 274 (1999).

However, in 1992, appalled at a bankruptcy court's order to cross-collateralize a whopping $24 million of pre-petition debt for the benefit of a single undersecured creditor, the Eleventh Circuit Court of Appeals dealt the practice of cross-collateralization a sudden, crippling blow. In the case of *In re Saybrook Manufacturing Co.*, Seymour and Jeffrey Shapiro, unsecured creditors of bankrupt Saybrook and its subsidiaries, formally objected to Saybrook's deal with Manufacturers Hanover Bank to secure the entirety of its pre-petition debt in return for financing. Whereas Manufacturers Hanover originally would have received less than $10 million for their claims against Saybrook, their cross-collateralization agreement entitled Manufacturers Hanover "to be paid in full" for its pre-petition claim in an amount totaling $34 million "before any funds could be distributed to the remaining unsecured creditors."[34]

To resolve the case, the Eleventh Circuit needed first to determine whether the mootness doctrine foreclosed the reversal of the cross-collateralization order, notwithstanding its adverse impact upon the Shapiros' claims.[35] Because its language expressly protected only financing orders "authorized under this section," the court deduced that Section 364(e) "is only applicable if the challenged lien or priority was authorized under section 364."[36] However, cross-collateralization was "not specifically mentioned in the Bankruptcy Code," let alone in Section 364.[37] Moreover, each of the four financing mechanisms endorsed by Section 364 empowered a debtor in possession *prospectively* to "obtain secured credit and incur unsecured debt,"[38] or similarly to engage in "the obtaining of credit or the incurring of debt."[39] The court interpreted this plain statutory language to apply "only to *future*—i.e., post-petition—extensions of credit," not

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[34] *See Saybrook*, 963 F.2d at 1491.

[35] *See id.* at 1492.

[36] 11 U.S.C. § 364(e) (2000); *Saybrook*, 963 F.2d at 1493.

[37] *Saybrook*, 963 F.2d at 1494.

[38] 11 U.S.C. § 364(a)-(b) (2000).

[39] 11 U.S.C. § 364(c)-(d) (2000).

to "the granting of liens to secure pre-petition loans."[40] Because none of the financing options in Section 364 described cross-collateralization, the court rejected the opinions of the Sixth and Ninth Circuits, and held that Section 364(e) could not shield a lender from relinquishing security that it received under an improper cross-collateralization order.[41]

Freed from the constraints of the mootness doctrine, the Eleventh Circuit proceeded to declare any cross-collateralization agreement to secure a pre-petition loan a violation of the Bankruptcy Code. Although the court recognized *Vanguard*'s legitimate concern for restoring debtors to profitability, it also emphasized that this end could not justify any illegal means of circumventing the enactments of the Bankruptcy Code.[42] By prioritizing the repayment of unsecured claims of creditor-lenders, cross-collateralization undermined the provisions of Section 507, in which Congress had established a ladder of precedence for payment of unsecured claims in liquidation.[43] In the court's view, although Section 105(a) did permit bankruptcy courts to "issue any order . . . necessary or appropriate" to carry out the provisions of the Bankruptcy Code, it surely did not grant judges the authority to create remedies that would otherwise violate it.[44] Whereas *Vanguard* and its progeny dismissed such arguments for the sake of assisting struggling businesses in their real efforts to obtain the financing required to continue their operations, *Saybrook* refused to compromise its formal understanding of the text of the Bankruptcy Code to accommodate such a lofty goal.

[40] *Saybrook*, 963 F.2d at 1495.

[41] *See id.* In opposition to widespread judicial support for cross-collateralization during the 1980's, two bankruptcy courts had arrived previously at this same conclusion pursuant to similar statutory analysis. *See In re* Tenney Vill. Co., 104 B.R. 562 (Bankr. D.N.H. 1989); *In re* Monach Circuit Indus., Inc., 41 B.R. 859 (Bankr. E.D. Pa. 1984).

[42] *See generally Saybrook*, 963 F.2d at 1496.

[43] *See id.* at 1495-96.

[44] 11 U.S.C. § 105(a) (2000); *see also Saybrook*, 963 F.2d at 1495-96.

D. Cross-Collateralization After *Saybrook*

Soon after the Eleventh Circuit handed down its ruling, numerous commentators and practitioners (especially counsel for large banks) decried *Saybrook* as an onerous hamper on the efforts of struggling businesses to reorganize their debt in Chapter 11 bankruptcy.[45] In defense of their position, some contended that the legal authority for cross-collateralization derives not from the Bankruptcy Code, but from its inherent role in fulfilling the Code's general aim to rehabilitate debtors.[46] Others offered a "no harm, no foul" justification: So long as unsecured pre-petition creditors do not object after the notice and hearing required by *Texlon*, "there can scarcely be any reason why [pre-petition cross-collateralization] should not be permitted."[47]

Despite these arguments, *Saybrook* nonetheless sought to curtail cross-collateralization on account of its incongruence with the financing mechanisms authorized by the statutory text of the Bankruptcy Code. The Eleventh Circuit's unbending interpretation of the Code constitutes a stark contrast to the reasoning of permissive bankruptcy courts who have endorsed cross-collateralization in the name of the nebulous policy goal of "debtor rehabilitation." Even after *Texlon* first questioned the propriety of post-petition security for pre-petition debt, bankruptcy judges, uniquely familiar with the fiscal constraints that corporate debtors faced in maintaining their operations, continued to issue cross-collateralization orders in large Chapter 11 cases throughout the 1980's.[48] Conversely, such realist concerns did not sway the Eleventh Circuit appellate judges, who did "not have extensive practical experience in adjudicating bankruptcy disputes."[49] Rather, pursuant to their strict textualist

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[45] *See* Tabb, *supra* note 28, at 111 n.12.

[46] *See* Leepson, *supra* note 5, at 799.

[47] David B. Young, *Preferences and Fraudulent Transfers*, 804 PLI/COMM 577, 679 (2000).

[48] *See* Leepson, *supra* note 5, at 800.

[49] *Id.*

reading of the Code, these judges viewed cross-collateralization as an illegal maneuver that allowed favored undersecured creditors to protect their own claims, while simultaneously shrinking the size of the asset pool available to unsecured creditors in liquidation.

The decision in *Saybrook* addressed an objection by unsecured creditors to an order authorizing cross-collateralization. Yet would this result necessarily have been the same if creditors had not objected or if a committee of creditors had supported the lending arrangement? At least in the Eleventh Circuit, *Saybrook* seems to suggest that cross-collateralization is absolutely prohibited. Thus, the Circuit Court concluded that "[c]ross-collateralization is directly inconsistent with the priority scheme of the Bankruptcy Code. Accordingly, the practice may not be approved by the bankruptcy court under its equitable authority."[50]

However, in the last decade, the practice of cross-collateralization has remained alive and well in many jurisdictions that have refused to follow the Eleventh Circuit's lead. In fact, the majority of bankruptcy courts outside the Eleventh Circuit "have concluded, for better or for worse, that cross-collateralization is permissible," so long as it passes the *Vanguard* test.[51] Even some Eleventh Circuit bankruptcy courts approved cross-collateralization orders by narrowly construing the holding of *Saybrook*.[52] Not only have bankruptcy courts limited or even ignored *Saybrook*, but also practitioners have developed a new, yet equally suspect incentive to convince undersecured creditors to lend to troubled business debtors. As a response to the

[50] *Saybrook*, 963 F.2d at 1496.

[51] Marcia L. Goldstein et al., *Current Issues in Debtor in Possession Financing*, SJ082 ALI-ABA 29, 39 (2004).

[52] *See* Bland v. Farmworker Creditors, 308 B.R. 109 (Bankr. S.D. Ga. 2003) (declaring that a *Saybrook* violation occurs only when cross-collateralization consumes unencumbered assets whose value would be apportioned among unsecured creditors in liquidation); *In re* Fla. W. Gateway, Inc., 147 B.R. 817 (Bankr. S.D. Fla. 1992) (distinguishing *Saybrook* as prohibiting cross-collateralization of only pre-petition debt).

reluctance of some judges to sanction cross-collateralization, bankruptcy attorneys have increasingly encouraged potential lenders "to improve their prepetition position by 'rolling' their prepetition debt into the postpetition facility."[53]

"Rollups" or "rollover financing" typically arise in situations in which the pre-petition lender holds a security interest in inventory and receivables. Under a rollup arrangement, the lender agrees to extend post-petition financing which will be secured by similar or enhanced collateral. However, during the post-petition period, the debtor agrees to apply all proceeds first toward payment of the pre-petition obligation.[54] In this way, the pre-petition loan is satisfied in full before any payment on account of the post-petition liability. Over time, the post-petition loan becomes an ever growing percentage of the total obligation, so that eventually the entire remaining obligation enjoys the benefit of administrative status. Unlike cross-collateralization, rollups do not create a grant of new security for any pre-petition claim. With the passage of time, however, rollups can provide the same protection as cross-collateralization. Although the Bankruptcy Code contains no specific authorization for rollups, they avoid the technical collateralization of any pre-petition position. For this reason, many bankruptcy judges have approved rollups, particularly in the popular Chapter 11 forum of the Southern District of New York.[55]

The growing prevalence of rollups represents lenders' successful adjustment to *Saybrook*: once the Eleventh Circuit blocked one perk for debtor-in-possession financing, lenders and their attorneys simply created a new one that they could employ as leverage in negotiations with needy

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[53] Goldstein, *supra* note 51, at 40.

[54] Richard M. Cieri et al., *Considerations for Chapter 11 Retail Debtors*, 6 J. BANKR. L. & PRAC. 451, 463 (1997).

[55] *See, e.g.*, *In re* County Seat Stores, Inc., No. 99-10010 (CB) (Bankr. S.D.N.Y. 1999); *In re* Cityscape Fin. Corp., Nos. 98-22569 and 98-22570 (ASH) (Bankr. S.D.N.Y. 1998); *In re* Caldor, Inc., No. 95-44080 (JLG) (Bankr. S.D.N.Y. 1995); *see also* Goldstein, *supra* note 51, at 40.

debtors. However, why should creditors deserve any incentives to lend at all? Even without the benefit of cross-collateralization or rollups, many pre-petition creditors should desire to lend anyway on account of their "strong . . . interest in seeing the debtor survive as a going concern."[56] This interest derives from two important considerations. First, secured and unsecured creditors receive a much smaller return on their claims in liquidation than they do in Chapter 11 reorganization, which enables a business to repay its debts from the cash flows generated by its continued operation.[57] Second, if a creditor has developed a long-term business relationship with a debtor over a number of years, it would prefer to help the debtor to salvage its operations, rather than to permanently lose a loyal customer. Thus, for many creditors, providing DIP financing without strings attached simply makes good business sense.

Subsequent to the decision in *Saybrook*, no other circuit has adopted its reasoning and rationale. *Saybrook*'s effort to enforce the Bankruptcy Code to its letter has not necessarily failed; indeed, no appellate court has repudiated its holding. Rather, the lack of case authority would seem to reflect the essential character of bankruptcy practice. Proceedings in Chapter 11 seek to develop a resolution by means of consensus. Where unsecured creditors would share no equity in any event, those creditors have no reason to challenge any financing arrangement, even if it provides for cross-collateralization. Taking into account the risks of a *Saybrook* result, debtors and secured creditors may be inclined to propose arrangements that will satisfy the concerns of unsecured creditors. Alternatively, the parties may simply avoid the issue, either by selecting a more favorable jurisdiction, or by devising a less obtrusive rollup arrangement.

For whatever reason, cross-collateralization has endured as a precondition for many DIP financing arrangements in jurisdictions that have declined to follow the lead of the

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[56] Burnett & Jacobs, *supra* note 28, at 518.

[57] *See* Gebbia & Oscar, *supra* note 12, at 237.

Eleventh Circuit in *Saybrook*. Notably, *Saybrook* illustrates the stark difference of opinion between bankruptcy specialists in the trenches of reorganization and the appellate judges committed to textualist statutory interpretation. Even though the Eleventh Circuit established a lead in rejecting the merits of cross-collateralization, bankruptcy judges and practitioners have often refused to follow. Regardless of the dubious policy justification for extra lending incentives, many bankruptcy courts have continued to approve cross-collateralization orders and rollover financing arrangements. The survival of cross-collateralization could foreshadow the extent to which other courts, most notably the Seventh Circuit Court of Appeals, may successfully influence their peers to curtail first-day critical vendor orders that similarly lack support in the text of the Bankruptcy Code.

III. CRITICAL VENDOR ORDERS

Whereas cross-collateralization grants a creditor a security interest in collateral, a first-day critical vendor order empowers a creditor to exact *actual, immediate payment* on its pre-petition unsecured claims as a prerequisite for continuing to supply the business debtor in bankruptcy with often highly-specialized goods or services that it needs to operate.[58] The order circumvents the usual rule that the filing of a Chapter 11 reorganization petition stays "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case."[59] In return for agreeing to extend credit terms identical to those that the debtor enjoyed before filing bankruptcy, the critical vendor enjoys full reimbursement on his claims long before non-critical unsecured creditors receive a single

[58] *See* Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors*: Capital Factors v. Kmart, 22-JUN AM. BANKR. INST. J. 1, 1 (2003); *see also* Robert A. Morris, *The Case Against "Critical Vendor" Motions*, 22-SEP AM. BANKR. INST. J. 30, 30 (2003).

[59] 11 U.S.C. § 362(a)(6) (2000).

penny.[60] Like the proponents of cross-collateralization, supporters of critical vendor orders trumpet their rehabilitative value for debtors, whose reorganization efforts would otherwise fail in the absence of ongoing commitment from their longtime suppliers.[61] Moreover, if critical vendor orders save a debtor's viability, then all of its creditors, critical or not, eventually benefit in the form of greater payments on their claims than they would have obtained in liquidation.

Like cross-collateralization, however, authority for critical vendor orders rests upon a rather suspect legal basis. Although bankruptcy courts have called upon common-law doctrine to justify critical vendor orders, the Bankruptcy Code nowhere mentions them in Section 507 among the explicit means by which an unsecured creditor may gain priority for repayment of his claims. Interpreting statutory silence as disapproval, the Seventh Circuit Court of Appeals in the case of *In re Kmart Corp.* affirmed the district court's reversal of an order that had permitted Kmart to pay millions of dollars in unsecured claims to creditors whom the nationally-known retailer had designated as critical. In mimicking the path taken by the Eleventh Circuit in *Saybrook*, the Seventh Circuit has also strictly construed the meaning of the Code to stamp out a common practice employed by practitioners and tacitly accepted by many bankruptcy judges. Yet despite the Seventh Circuit's noble effort, the resurrection of cross-collateralization from the ashes of *Saybrook* portends a similar ascendancy for critical vendor orders. Widespread support among bankruptcy practitioners and jurisdictions outside the Seventh Circuit for offering incentives to DIP suppliers, combined with dicta in *Kmart* that offered a possible statutory basis for essential

[60] *See* Bruce S. Nathan, *Critical Vendors: Elevating the Low-priority Unsecured Claims of Pre-petition Trade Creditors*, 21-JUN AM. BANKR. INST. J. 14, 14 (2002).

[61] *See generally* Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 420 (2003).

payments, suggests that critical vendor orders shall represent useful items in the bankruptcy judge's first-day toolbox for years to come.

A. The Development of the Law of Critical Vendor Orders

Over one hundred years ago, the Supreme Court established the foundation for the "doctrine of necessity," a common-law rule that has traditionally validated critical vendor payments. Recognizing the importance of railroads to the prosperity of the American economy, the Supreme Court in 1882 authorized a rail line in "receivership" (a forerunner to modern bankruptcy) to compensate "necessary and indispensable" suppliers on their pre-existing claims.[62] Since this seminal decision, numerous other courts have invoked this doctrine to uphold bankrupt railroads' payments to essential vendors as necessary "to prevent the stoppage of a business impressed with the public interest."[63]

Gradually, the courts have expanded the doctrine of necessity to apply to vendor payments made not just by railroads, but by any bankrupt business. Although priority for the claims of unsecured creditor-suppliers originally rested upon "the interest of the public in the continued operation of the railroads," Judge Learned Hand first argued that such priority merited a "larger basis."[64] Judge Hand endorsed a bankrupt hotel's reimbursement of an unsecured supplier for two policy reasons. First, payment ensured that the supplier would continue to provide goods required for the hotel's sustained operation, which would preserve its value for the benefit of its secured creditors.[65] Second, a bankrupt business often lacks sufficient cash flows to obtain goods

[62] Miltenberger v. Logansport, C & S.W.R. Co., 106 U.S. 286, 311 (1882).

[63] *See also, e.g.*, *In re* Lehigh & New England Ry. Co., 657 F.2d 570 (3d Cir. 1981); *In re* Penn Cent. Transp. Co., 467 F.2d 100 (3d Cir. 1972); *In re* Mich. Interstate Ry. Co., 87 B.R. 921 (Bankr. E.D. Mich. 1988).

[64] Dudley v. Mealey, 147 F.2d 268, 271 (2d Cir. 1945).

[65] *See id.*

under cash-on-delivery ("C.O.D.") terms that its suppliers would likely demand as protection in the absence of a critical vendor order.[66]

Upon enacting the new Bankruptcy Code in 1978, Congress passed on its opportunity to adopt Judge Hand's reasoning and enshrine critical vendor orders in statutory language. Nonetheless, over the past twenty-five years, multiple courts have approved critical vendor orders pursuant to the doctrine of necessity for businesses engaged in an array of endeavors unrelated to public transportation. In addition to citing Judge Hand's policy concerns, these courts have also attempted to rationalize the validity of critical vendor orders by broadly interpreting sections of the Code that do not explicitly address such payments. Their efforts have yielded four distinct statutory arguments in favor of critical vendor orders.

The first argument relies *solely* upon the bankruptcy court's power under Section 105(a) to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Code."[67] Pursuant to this provision, courts in the Third Circuit have generally authorized the reimbursement of vendors' pre-petition unsecured claims so long as that payment is "essential to the continued operation of the debtor."[68] Another bankruptcy judge has also called upon Section 105(a) alone to substantiate a similar standard for evaluating a vendor order based upon the extent of its status as "critical to the [d]ebtor's reorganization."[69]

The three remaining justifications for critical vendor orders have all cited Section 105(a) in tandem with other parts of the Bankruptcy Code. The first of these, initially

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[66] *See id.*

[67] 11 U.S.C. § 105(a) (2000).

[68] *In re* Just for Feet, Inc., 242 B.R. 821, 825 (Bankr. D. Del. 1999). *See also In re* Columbia Gas Sys., Inc., 171 B.R. 189, 191-92 (Bankr. D. Del. 1994).

[69] *In re* Wehrenberg, Inc., 260 B.R. 468, 469 (Bankr. E.D. Mo. 2001). *See also In re* Fin. News Network, Inc., 134 B.R. 732, 736 (Bankr. S.D.N.Y. 1991).

proposed in the case of *In re Ionosphere Clubs, Inc.*,[70] fortifies the reasoning of Section 105(a) with the bankruptcy trustee's Section 363(b)(1) power, "after notice and a hearing," to "use, sell, or lease, other than in the ordinary course of business, property of the estate."[71] Section 363(b)(1) does not automatically validate every critical vendor order, but rather only orders backed by sufficient "business justification."[72] Nonetheless, a bankrupt debtor may easily meet this test by demonstrating under the doctrine of necessity the importance of paying vendors' pre-petition claims "in order to preserve and protect its business and ultimately reorganize."[73] Thus, *Ionosphere* argues for critical vendor orders not only by scraping for support in the text of the Bankruptcy Code, but also by emphasizing debtor rehabilitation as a worthy policy goal.[74]

Over a decade after *Ionosphere*, a new case, *In re Payless Cashways, Inc.*,[75] offered new reasoning that relies on an expansive view of Section 364(b) of the Bankruptcy Code, which enables a debtor's trustee "to obtain unsecured credit or to incur unsecured debt."[76] On its face, this section governs only a debtor's prospective obligations that arise after it files a bankruptcy petition. Yet *Payless Cashways* interpreted the debtor's abilities to retain credit and to incur debt under Section 364(b) not as mere privileges, but as rights. In the court's view, "if the debtor is to obtain credit, it may well need to offer something to its suppliers."[77] Therefore, the debtor's desire for favorable credit terms in its

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[70] 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

[71] 11 U.S.C. § 363(b)(1) (2000).

[72] *Ionosphere*, 98 B.R. at 175.

[73] *Id.*

[74] For additional cases that have favored the *Ionosphere* analysis as properly promoting debtor rehabilitation, *see, e.g.*, *In re* Colonial Health Investors, LLC, 2001 WL 34388127 (Bankr. W.D.N.C. 2001); *In re* NVR L.P., 147 B.R. 126 (Bankr. E.D. Va. 1992); *In re* Chateaugay Corp., 118 B.R. 19 (Bankr. S.D.N.Y. 1990).

[75] 268 B.R. 543 (Bankr. W.D. Mo. 2001).

[76] 11 U.S.C. § 364(b) (2000).

[77] *Payless Cashways*, 268 B.R. at 547.

purchase of goods essential to sustain its business operations validates a critical vendor order designed to extract such terms from otherwise leery suppliers.

The final statutory argument, presented by *In re CoServ, LLC*,[78] seeks "to get from section 105(a) to the Doctrine of Necessity" by "[finding] a bridge that makes application to the Doctrine of Necessity 'necessary or appropriate to carry out the provisions of' the Bankruptcy Code."[79] *CoServ* identifies this bridge in Section 1107(a), which generally equates the rights of a DIP with those of a trustee in bankruptcy, and designates the DIP as a "fiduciary . . . operating the business for the benefit of its creditors."[80] Thus, a critical vendor order has merit if it assists the DIP in maintaining the value of the bankrupt estate for eventual compensation of the claims of secured creditors. After rejecting the "facilitation of rehabilitation" (proposed by *Ionosphere*) and "critical to reorganization" standards as devoid of "meaningful guidance to practitioners" wishing to prove the necessity of a critical vendor order, *CoServ* adopted its own three-part test, also marred by ambiguous terminology.[81] A critical vendor order satisfies the *CoServ* test if the debtor's dealing with the vendor is "*virtually indispensable* to profitable operations or preservation of the estate," if the failure to deal with the vendor "risks *probable harm* or eliminates an economic advantage *disproportionate*" to the amount of the vendor's claim, and if there exists no

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[78] 273 B.R. 487 (Bankr. N.D. Tex. 2002).

[79] *Id.* at 496-97 (quoting 11 U.S.C. § 105(a) (2000)).

[80] *Id.* The text of 11 U.S.C. § 1107(a) (2000) reads as follows:

> Subject to any limitations on a trustee serving in a case under this chapter, and to such limitations or conditions as the court prescribes, a debtor in possession shall have all the rights, other than the right to compensation under section 330 of this title, and powers, and shall perform all the functions and duties, except the duties specified in sections 1106(a)(2), (3), and (4) of this title, of a trustee serving in a case under this chapter.

[81] *CoServ*, 273 B.R. at 498.

alternative to payment of the claim to maintain the relationship between debtor and vendor.[82]

Despite these four contentions grounded in the text of the Bankruptcy Code, some courts still refused to endorse critical vendor orders because they grant favored vendors on their unsecured claims priority of repayment for which the Code does not expressly provide.[83] However, these cases proved the exception rather than the norm, as critical vendor orders grew more prevalent among the many first-day orders issued by bankruptcy judges during the 1980s and 1990s. Because they typically are issued on the first day of a bankruptcy case, critical vendor orders often encounter little or no opposition from non-essential trade creditors, most of whom lack knowledge of the filing of the petition.[84] For this reason, by one practitioner's assessment, critical vendor orders represented the "dirty little secret in the bankruptcy community": even though their legality rested on shaky statutory grounds, they had "become standard procedure in any operating company Chapter 11 proceeding."[85]

On January 25, 2002, pursuant to this standard procedure, Northern District of Illinois Bankruptcy Judge Susan Sonderby cited her authority under Bankruptcy Code Section 105(a) in granting national retailer Kmart's first-day request for an order that would enable Kmart to pay the unsecured claims of pre-petition "critical" trade creditors of its own choosing, so long as they would agree to "furnish

[82] *Id.* at 498-99 (emphasis added).

[83] *See, e.g.*, Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt., Inc.), 4 F.3d 1329 (5th Cir. 1993) (holding that Section 105(a) may be applied only in a manner consistent with the enactments of the remainder of the Bankruptcy Code); B & W Enters., Inc. v. Goodman Oil Co. (*In re* B & W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983) (holding that the doctrine of necessity controls only in cases involving bankrupt railroads); FCX, 54 B.R. 833 (declaring that the courts cannot alter the priority structure established by the text of the Bankruptcy Code);

[84] *See* Gilday, *supra* note 61, at 415.

[85] Thomas J. Salerno, *"The Mouse That Roared," Or, "Hell Hath No Fury Like a Critical Vendor Scorned,"* 22-JUN AM. BANKR. INST. J. 28, 28 (2003).

goods on 'customary trade terms'" for two years thereafter.[86] However, the bankruptcy court approved the critical vendor order over the strident objection of Capital Factors, a special purpose vehicle ("SPV") that purchased accounts receivable from Kmart's clothing suppliers and that possessed $20 million in unsecured non-critical claims.[87] Over the next two years, Kmart exercised its power under the order to pay $300 million in pre-petition debt to over 2,000 suppliers, while simultaneously leaving another 2,000 non-critical creditors like Capital Factors unpaid.[88]

Yet, in 2003, Capital Factors successfully appealed the order to the district court, which ruled that Section 105(a) and the doctrine of necessity alone could not justify the practice of issuing critical vendor orders.[89] Kmart subsequently appealed this reversal to the Seventh Circuit Court of Appeals in Chicago. Notwithstanding the Seventh Circuit's eventual decision, bankruptcy practitioners were generally surprised at the district court's challenge to the legal basis for critical vendor orders in such a large and complicated case as *Kmart*. The remarks of one attorney encapsulated their overall reaction well:

> Well, again, many of us involved in the [*Kmart*] case didn't pay much attention to [Capital Factors'] appeal. Most of us thought it had little chance of success because ruling in favor of Capital Factors could be very disruptive to the result of the *Kmart* case. And, frankly, most of us bankruptcy professionals and most of the judiciary have gotten used to this idea of the Doctrine of Necessity. We haven't actually questioned its underpinnings. We may feel . . . that it may have gotten abused, but

[86] *Kmart*, 359 F.3d at 868-9.

[87] *See* Capital Factors, Inc. v. Kmart Corp., 291 B.R. 818, 820 (N.D. Ill. 2003).

[88] *See Kmart*, 359 F.3d at 869.

[89] *See Capital Factors*, 291 B.R. at 823.

> nobody actually questioned whether or not it existed. It has been with us for a long period of time.[90]

For lawyers in the trenches of bankruptcy practice, the critical vendor order had evolved into such a commonplace maneuver that they could not imagine a playing field that excluded it. Thus, regardless of the text of the Bankruptcy Code, most practitioners agreed that the district court's ruling would "eventually be overturned because the Doctrine of Necessity is a very critical doctrine."[91]

B. *Kmart* Delivers a Setback

In writing for the panel in *Kmart*, Judge Frank Easterbrook acknowledged the policy justifications that underlie most arguments in support of critical vendor orders. Indeed, Kmart's suppliers might "be unwilling to do business with a customer that is behind in payment, and, if [Kmart] cannot obtain the merchandise that its own customers have come to expect . . . Kmart may be unable to carry on, injuring all of its creditors."[92] For Judge Easterbrook, however, these policy considerations meant little if the text of the Bankruptcy Court did not permit critical vendor orders.[93] Although Judge Sonderby had invoked the "necessary or appropriate" clause of Section 105(a), this rule alone did not entitle a bankruptcy judge to alter the priority structure for payment of unsecured claims established in other sections of the Code.[94] Moreover, the nineteenth-century common-law doctrine of necessity could not override the will of Congress as expressed in the 1978 statute, which failed to approve

[90] Richard M. Cieri et al., *Panel 1: Forum Shopping, First Day Orders, and Case Management Issues in Bankruptcy*, 1 DEPAUL BUS. & COM. L.J. 515, 533 (2003).

[91] *Id.* at 536.

[92] *Kmart*, 359 F.3d at 868.

[93] Judge Easterbrook has long advocated the merits of strict textualism in statutory interpretation. *See, e.g.*, Frank Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 544-52 (1983).

[94] *See Kmart*, 359 F.3d at 871.

critical vendor orders as an appropriate inducement for DIP financing.[95]

Judge Easterbrook also rejected the application of the analyses of *Payless Cashways* and *Ionosphere* to validate Kmart's critical vendor order. Easterbrook swiftly dismissed the reasoning in *Payless Cashways* on the ground that Section 364(b) does not at all govern the priority of unsecured creditor reimbursement, and hence cannot offer a means of avoiding the requirements of the Section 507 repayment scheme.[96] In contrast, *Ionosphere*'s argument was "more promising" because "satisfaction of a pre-petition debt in order to keep 'critical' supplies flowing is a 'use of property'" under Section 363(b)(1).[97] In dicta, Easterbrook proposed that so long as the critical vendor order achieved the policy goal of inducing trade creditors to continue to supply a debtor, and so long as it would not impair the extent of non-critical creditors' recovery in the possibility of Chapter 7 liquidation, the order could enjoy authorization pursuant to Section 363(b)(1).[98] However, because Kmart's arguments failed to fulfill either prong of this test, the court ruled that the critical vendor order could not stand.

Indeed, other appellate decisions before *Kmart* also determined that critical vendor orders did not accord with the statutory mandates of the Bankruptcy Code.[99] Yet *Kmart* represents a watershed decision in the history of critical vendor orders not primarily for its legal conclusions, but rather for the massive relief that it granted Capital Factors and other non-critical trade creditors. Despite Kmart's protestations, the Seventh Circuit ordered Kmart to recoup the $300 million that it had already paid its critical vendors. Like the *Saybrook* court, the Seventh Circuit refused to apply the mootness doctrine of Section 364(e) in the absence

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95 *See id.* at 871-72.

96 *See id.* at 872.

97 *Id.*

98 *See id.* at 872-73.

99 *See* cases cited *supra* note 83.

of explicit statutory approval for critical vendor orders.[100] The wide-ranging refund mandated by Judge Easterbrook and the Seventh Circuit not only ostensibly impacted the course of Kmart's Chapter 11 reorganization, but also created a troubling dilemma for critical trade creditors in numerous other cases. Even if a creditor makes it onto a debtor's critical list, and enjoys prompt reimbursement of his pre-petition claims pursuant to a bankruptcy court order, a higher court on appeal could later reverse the order and force that creditor to return the sum of the repayment. Therefore, unless authorized by a final order that is no longer subject to appeal, a creditor in receipt of a critical vendor payment may not safely rely on that payment in planning its financial future.

C. Are Critical Vendor Orders in Critical Condition After *Kmart*?

Because the Seventh Circuit rendered its decision in February 2004, *Kmart*'s impact on the prevalence of critical vendor orders in large-scale reorganization cases remains to be seen. However, one may extrapolate from the past experience with cross-collateralization to predict the future of critical vendor orders. *Saybrook*'s overall failure to end the practice of granting incentives to creditors in return for extending DIP financing demonstrates the uncanny ability of bankruptcy specialists to adapt successfully to judicial attempts to alter the rules of reorganization to which they have grown accustomed. Even though many trade creditors are not so "critical" as to deserve expedited reimbursement on their unsecured claims, bankruptcy attorneys likely will work to circumvent *Kmart*, or alternatively to develop new incentives to encourage demanding vendors to continue supplying their insolvent business customers.

The debate over critical vendor orders signifies an ardent battle between realists who willingly bend the language of the Bankruptcy Code to achieve the purpose of debtor

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[100] *See Kmart*, 359 F.3d at 869.

rehabilitation versus formalists who refuse to compromise the plain meaning of the statutory text. While both sides have presented an even balance of convincing arguments to defend their viewpoints, a realist contention raised by Judge Easterbrook in *Kmart* stands to tip this balance in favor of the strict constructionists. Bankruptcy specialists have foretold doomsday scenarios for debtors in a world without critical vendor orders; trade creditors would halt their supply deliveries, and thereby doom the operations of salvageable businesses.[101] For Judge Easterbrook, however, these prophecies constitute gross exaggerations for two reasons. First, many vendors would continue to supply if their own fortunes depended heavily upon the debtor's patronage.[102] For example, one notable critical vendor received between $70 and $100 million in orders from Kmart *each week*.[103] Even if this vendor possessed outstanding unsecured claims, abandoning its relationship with Kmart would not make good business sense. As Judge Easterbrook incisively observed, "Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop this account? That would be a self-inflicted wound. . . . [The vendor] might as well burn money or drop it into the ocean."[104] Second, the usual vendor, critical or not, has promised in its contract with the debtor to supply inventory over the duration of the agreement. An abrupt end to deliveries would breach the contract, and expose the vendor to possible liability for damages. Given these common-sense incentives for continuing to supply the bankrupt debtor, why should the vendor deserve an additional inducement of an order for immediate payment of its unsecured claims? Just as an undersecured creditor would benefit financially from the debtor's successful

[101] *See generally* Bruce H. White & William L. Medford, *The Doctrine of Necessity and Critical Trade Vendors*, 21-SEP AM. BANKR. INST. J. 24, 36-37 (2002).

[102] *See Kmart,* 359 F.3d at 873.

[103] *See id.*

[104] *Id.*

reorganization without the extra perk of cross-collateralization, the vendor's preference to earn more profit and aversion to costly litigation should provide enough incentives to maintain his business relationship with the debtor.[105]

Nonetheless, the generally permissive attitude among bankruptcy judges toward critical vendor orders has increasingly emboldened trade creditors to demand critical status from newly bankrupt debtors. Indeed, "a debtor is typically besieged in the first days of a [C]hapter 11 case with thinly veiled demands by creditors for preferential treatment of outstanding obligations."[106] "Until there is clear authority" that prevents any bankruptcy judge from granting extrastatutory preferential reimbursement to favored creditors, "the approval of motions to pay critical vendors is likely to continue."[107]

For two reasons, *Kmart* does not represent such clear authority, despite the Seventh Circuit's valiant effort to enforce the plain meaning of the text of the Bankruptcy Code. First, *Kmart* did not outlaw critical vendor orders *entirely*. Rather, in dicta, the Seventh Circuit suggested that Section 363(b)(1), upon which *Ionosphere* relied in 1989, could justify preferential vendor payments that would not worsen the ability of non-critical creditors to recoup their claims in reorganization as compared with liquidation, and that would enable truly critical creditors to continue their

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[105] *See generally* Mette H. Kurth, *First Among Equals?: Maybe Not—The Search for "Critical Vendor" Status*, 14 BUS. L. TODAY 17, 20-22 (2004) ("supposedly critical vendors either can be replaced without devastating consequences or will likely continue to do business with the debtor irrespective of the status of their pre-petition claims"). Of course, this incentive to deliver goods will presume a prompt receipt of payment for goods already delivered post-petition. Otherwise, the vendor has reason to fear that it will never receive payment and that any shipment is to a risky venture.

[106] Steven N. Cousins et al., *First Day Orders: An Examination*, 11 J. BANKR. L. & PRAC. 213, 214 (2002).

[107] Victor A. Vilaplana, *Stretching the Code for Critical Vendors: Necessity Is the Mother of Invention*, 862 PLI/COMM 491, 535 (2004).

deliveries. Mindful of this analysis, a debtor seeking bankruptcy court approval of a critical vendor order can tailor its case to satisfy both prongs of this test.[108] Moreover, *Kmart* did not pass judgment on the merit of the *Coserv* test, which predicated the validity of critical vendor payments upon the Section 1107 rights of a debtor in possession. Thus, rather than curtail critical vendor orders altogether, *Kmart* has enhanced the ability of bankruptcy practitioners to predict reasoning that might win over an otherwise skeptical judge concerned about honoring the text of the Code.

Second, and perhaps more importantly, *Kmart* does not change the fact that most bankruptcy courts in most judicial circuits still regularly issue critical vendor orders on debtors' requests.[109] Many bankruptcy courts, particularly in the Southern District of New York, persist in endorsing cross-collateralization arrangements, and *Saybrook*'s impact has remained relatively limited to the Eleventh Circuit. Like the bankruptcy specialists who employed rollups to afford lenders benefits similar to those of cross-collateralization, practitioners disgruntled with *Kmart* can adapt by simply avoiding the Seventh Circuit and shopping for another forum for their filings. The ideal candidate for a new favorite forum is the Third Circuit (which includes Delaware, a popular incorporation venue), where case law has consistently permitted critical vendor orders under the doctrine of necessity and the bankruptcy judge's discretion to take "necessary or appropriate" actions under Section 105(a) of

[108] *See* Roger M. Whelan, *Caveat Vendor: Doctrine of Necessity Down but Not Out*, 23-APR AM. BANKR. INST. J. 18 (2004) (noting that a practitioner can meet the *Kmart* test by making an evidentiary showing of the order's necessity, and by presenting a "critical-vendor analysis" that "narrows down those candidates who might justify [such] extraordinary treatment"). *See also* Kurth, *supra* note 105, at 22 ("[*Kmart*] does not necessarily prohibit critical vendor motions, but rather, it raises the procedural and evidentiary requirements for their approval").

[109] To date, in their published decisions, bankruptcy courts outside the Seventh Circuit have chosen not to follow the holding of *Kmart*. *See In re* Tropical Sportswear Int'l Corp., 320 B.R. 15 (Bankr. M.D. Fla. 2005); *In re* CEI Roofing, Inc., 315 B.R. 50 (N.D. Tex. 2004).

the Bankruptcy Code.[110] Ideally, *Kmart* would have curtailed critical vendor orders by eliminating them as a legally viable incentive that trade creditors could demand. So long as other courts disagree with the Seventh Circuit's opinion, however, vendors can continue to lobby for preferential treatment of their unsecured claims as leverage against newly insolvent debtors. Rather than risk an unpleasant confrontation with suppliers, counsel for a large-scale business debtor will likely choose the path of least resistance, and file for Chapter 11 reorganization in a forum friendly to requests for critical vendor orders.

IV. CORPORATE GOVERNANCE IN CHAPTER 11 REORGANIZATION

Over the last decade, some DIP financers (usually large banks) have increasingly requested partial control over their debtors' business operations before consenting to lend. Such lender governance mechanisms, formally enshrined in a written DIP financing agreement, may include the creditor's right to select new members of the debtor's board of directors, to discontinue cash flow upon the debtor's failure to meet established targets for rehabilitation, or even to determine when the debtor must file a plan for reorganization in bankruptcy.[111] As a consequence, the "DIP loan agreement has become the single most important

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[110] *See, e.g.*, *Lehigh & New England Ry.*, 657 F.2d 570; *Penn. Cent. Transp.*, 467 F.2d 100; *Just for Feet*, 242 B.R. 821; *Columbia Gas*, 171 B.R. 189. *See also* Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 VAND. L. REV. 1987, 1992 (2002) (noting that Delaware, on account of its status as "the most popular state of incorporation," represents an ideal forum in which to file for bankruptcy protection). *See also* Timothy R. Pohl & Rena M. Samole, *The Delaware Alternative*, 853 PLI/COMM 189 (2003) (listing numerous orders in which Delaware bankruptcy judges have endorsed preferential payments to critical vendors).

[111] *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses of the Twenty-first Century?*, 78 AM. BANKR. L.J. 153, 185 (2004).

governance lever in many larger Chapter 11 cases."[112] Although the Bankruptcy Code does not explicitly prohibit these or other conditions for lending, leading academics have expressed apprehension over their roles not only in holding businesses hostage to the will of a few key creditors, but also in promoting early, "inefficient liquidations" of enterprises that could otherwise survive.[113]

However, lessons from the debates over cross-collateralization and critical vendor orders counsel that the courts may not be able to solve such concerns by interfering with the troubled debtor's prerogative to contract freely with creditors for financing under terms to which they mutually assent. Whereas cross-collateralization and critical vendor orders created priorities for claims of unsecured creditors that contravened the statutory enactments of the Bankruptcy Code, the Code does not purport to limit a DIP financer's ability to protect its investment by monitoring and influencing its debtor's operations.[114] Therefore, there exists insufficient basis in law for courts to tackle the issue of corporate governance by DIP lenders, despite the model efforts of the Eleventh Circuit in *Saybrook* and the Seventh Circuit in *Kmart*. Moreover, because of the growing prevalence of control devices in DIP financing agreements, the insufficiency of many solutions proposed to reverse this trend, and the ability of bankruptcy specialists to shop for favorable forums in which to file their cases, judicial

[112] David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-possession Financing*, 25 CARDOZO L. REV. 1905, 1906 (2004).

[113] Robert K. Rasmussen, *Secured Credit, Control Rights and Options*, 25 CARDOZO L. REV. 1935, 1937 (2004).

[114] This is not to say that a DIP agreement might not impose terms that effectively violate the normal rules of priority and entitlement. For example, in the case of *In re* Bush Indus., Inc., 315 B.R. 292 (Bankr. W.D.N.Y. 2004), the court denied confirmation of a reorganization plan whose terms were mandated by a "Lock Up and Voting Agreement." The court ruled that although a "lock up agreement does not *per se* indicate a lack of good faith," the agreement nonetheless imposed terms that were improper. 315 B.R. at 304. In that case, the court refused to approve plan provisions relating to executive compensation, whose payment would effectively preclude distributions to equity holders.

endeavors to deal with DIP lenders' governance would likely accomplish nothing.

A. The Rise of DIP Financing Covenants

Professor David Skeel has traced the development of governance mechanisms in DIP lending to railroad bankruptcies of the 1800s.[115] To prevent interruptions in the rail service that then drove the American economy, the Supreme Court entitled early DIP suppliers to full payment on claims that arose within six months of a railroad's receivership.[116] Although these vendors did not exert control over the railroad's operations, prominent Wall Street bankers and attorneys often negotiated the terms of restructuring by which its managers would abide.[117] In 1938, a New Deal Congress, suspicious of these dealmakers, revamped this process to require federal courts to appoint independent trustees who would oversee the governance of large businesses in what was then Chapter X bankruptcy.[118] Though trustees temporarily "took the place that had previously been occupied by the Wall Street banks and bar," by the 1960s, many corporate debtors seeking to maintain their autonomy cleverly had opted to file for Chapter XI bankruptcy, which did not provide for mandatory selection of a trustee.[119]

The 1978 revision of the Bankruptcy Code took two important cues from this history. First, in Section 364, the Code created procedures that persuaded lenders to extend credit to insolvent debtors. Like the old "six months' rule," Section 364 enabled most creditors' unsecured loans to enjoy priority as administrative expenses over previous unsecured

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[115] *See* Skeel, *supra* note 112. For another complete account of this history, *see* Miller & Waisman, *supra* note 111.

[116] *See* Skeel, *supra* note 112, at 1910. *See also* Fosdick v. Schall, 99 U.S. 235 (1878).

[117] For a complete description of receivership, *see* Skeel, *supra* note 112, at 1908-10.

[118] *See id.* at 1913-14.

[119] *Id.* at 1914.

claims, and even over previous property lienholders.[120] Second, the Code dispatched the restrictive governance provisions of the old Chapter X in favor of Chapter XI's leniency. Thus, the current Chapter 11 does not require the appointment of a trustee to run a bankrupt business.[121] For Professor Skeel, these tandem factors interacted to encourage DIP lenders in the 1990's to offer credit, but only under specific conditions for which the lender and the debtor contracted. The absence of a mandatory role for trustees in Chapter 11 presented DIP lenders with an opportunity to "fill the governance vacuum" by wresting control of a debtor's operations from pre-existing management.[122]

Today, DIP lending covenants may grant a lender a wide spectrum of powers over an insolvent business' corporate governance. Some bestow control over the debtor's financial decisions. For instance, a loan agreement may establish "drop dead" dates that force the debtor to confirm a reorganization plan soon after filing for bankruptcy, or otherwise liquidate.[123] Most loan agreements also restrict operating expenses under penalty of a sudden decrease in cash flow, which would likely cause the debtor to sell a portion of its assets to meet its obligations.[124] Additional financial caveats may include revenue-based performance targets and the limitation of "payment of pre-petition claims even if approved" by the bankruptcy court.[125] To ensure the proper implementation of these and other financial provisions, other lending covenants have dictated the "who" and "how" of a debtor's decision-making. Most notably, lenders often require a debtor to appoint not a trustee, but a "chief restructuring officer" ("CRO") from a list of acceptable

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[120] *Id.* at 1915-16. *See also* 11 U.S.C. § 364 (2005).

[121] *See* Skeel, *supra* note 112, at 1914.

[122] *Id.* at 1916.

[123] *Id.* at 1918 (describing such a covenant that factored prominently in the bankruptcy of toy retailer F.A.O. Schwarz).

[124] *See id.* at 1919. *See also* Miller & Waisman, *supra* note 111, at 185.

[125] Miller & Waisman, *supra* note 111, at 185.

candidates.[126] Also, the lender may establish a schedule of dates on which the debtor must reject various executory contracts or file a plan of reorganization.[127]

In response to these emerging mechanisms of strict lender control over the weary debtor, at least one bankruptcy judge has called them "unnecessary, overreaching or just plain wrong."[128] Of course, the DIP financer would argue that he must stringently oversee his debtor's operations to prevent inept managers, whose earlier financial decisions likely landed the debtor in bankruptcy in the first place, from squandering his investment. In particular, secured DIP lenders must keep vigilant watch for the diminution of the value of the debtor's collateral. Once a debtor corporation's assets irreparably lose their value, "keeping the corporation going is a money-losing proposition" for the DIP financer.[129] In anticipation of such a turn of events, the DIP financer would require appropriate authority to make the tough, yet prudent, choice to pull the plug on the debtor—especially if the original managers would refuse to shut down for sentimental or other reasons.

However, leading academics have warily observed the rise of DIP financing covenants, and have raised three contentions to substantiate their suspicion. First, drop-dead provisions, especially those that trigger an abrupt halt to the flow of financing, discourage debtors from engaging in risky transactions that could potentially yield great fiscal benefits. While the lender seeks to prevent behavior that could jeopardize its investment, the debtor's managers wish to avoid "unduly risky transactions" whose failure might imperil their job security under the terms of the loan

[126] Douglas Baird & Martin Bienenstock, *Panel 5: Debtor-in-Possession Financing (Pre-petition & Lock-up Agreements)*, 1 DEPAUL BUS. & COM. L.J. 589, 591-92 (2003). *See also* Robert K. Rasmussen, *Integrating a Theory of the State into Sovereign Debt Restructuring*, 53 EMORY L.J. 1159, 1170 (2004).

[127] *See* Miller & Waisman, *supra* note 111, at 185.

[128] *Id.*

[129] Skeel, *supra* note 112, at 1924.

agreement.[130] These self-serving disincentives can combine to "discourage even appropriate risk-taking" if the "DIP lender tighten[s] the screws too much" on the managers' ability to make their own decisions in their best business judgment.[131]

Second, lending covenants deprive debtors of "exit strategies" that could extricate them from a creditor's repressive control. In theory, managers unhappy with a lender's influence over the debtor's operations could shop among a number of banks for a new source of financing. In practice, however, DIP lenders usually foreclose this option by taking a security interest in the debtor's cash flow.[132] As a consequence, the debtor retains few unencumbered assets sufficient to collateralize a loan from another financer. Thus, the debtor must submit to its lender's will as expressed by the terms of its covenant, or otherwise lose necessary financing altogether.

Finally, the strictest lending covenants can result in economically inefficient business choices. As Professor Skeel has observed, the DIP financer "face[s] a downside risk if the debtor's fortunes are volatile, but [its] upside potential is fixed."[133] Therefore, at the first sign of a debtor's worsening financial condition, the lender would prefer to force an asset sale by discontinuing the stream of credit to the firm, rather than await a recovery that might never materialize.[134] Such

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[130] Douglas G. Baird & Robert K. Rasmussen, The New Agents of Enterprise 14 (2004) (unpublished manuscript, on file with the author).

[131] Skeel, *supra* note 112, at 1924.

[132] *See* Baird & Rasmussen, *supra* note 130, at 18.

[133] David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 937 (2003) (footnote omitted).

[134] *See id.* One may often see this preference for liquidation in the context of competing reorganization plans, such that the court must select between a creditor's plan of liquidation and the debtor's proposal for rehabilitation. *See, e.g.*, Jorgensen v. Fed. Land Bank of Spokane (*In re* Jorgensen), 66 B.R. 104 (B.A.P. 9th Cir. 1986); *In re* Holley Garden Apartments, Ltd., 238 B.R. 488 (Bankr. M.D. Fla. 1999); *In re* Crosscreek Apartments, Ltd., 213 B.R. 521 (Bankr. E.D. Tenn. 1997); *In re* River Village Assocs., 161 B.R. 127 (Bankr. E.D. Pa. 1993).

prompt liquidation might serve the interests of the risk-averse lender, but it may not necessarily comport with the prerogatives of the debtor's shareholders, whose knowledge of the business might instruct them to hold out for better times.[135] In enabling the lender to pull the plug on the debtor's operations too easily, governance mechanisms not only promote inefficient liquidation, but also undermine the function of Chapter 11 to assist the debtor in reorganizing and rehabilitating its financial posture, not in totally shutting down.

DIP lending covenants are essentially unlimited in their variety and scope. Under certain circumstances, such covenants may cause premature liquidation, and thereby reduce distributions to unsecured creditors. Other covenants may materially enhance the rights of secured creditors, but to the detriment of other creditors and equity holders. On the other hand, appropriate covenants may serve merely to assure a timely reorganization that inures to the best interests of all parties. Unlike cross-collateralization and payments to critical vendors, lender covenants generally speak to the exercise of sound business judgment. For this reason, DIP lending covenants often present no clear distinction between proper and improper conduct. Thus, judicial review of these agreements should prove more problematic.

B. How Should the Courts Respond?

The policy arguments against restrictive loan covenants reflect well-meaning concern for the preservation of Chapter 11 bankruptcy as a viable avenue by which troubled business debtors may earn fresh opportunities for profitability. However, from a normative perspective, the courts should avoid interfering in the rights of DIP financers and business debtors to contract privately for lending terms that do not violate the Bankruptcy Code. In addition, the resurrection of cross-collateralization from the ashes of *Saybrook*, along with

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[135] *See* Baird & Rasmussen, *supra* note 130, at 33.

the likely survival of critical vendor orders after *Kmart*, forecasts the impracticality and inefficacy of any judicial efforts to legislate regulations on lending covenants.

Opponents of cross-collateralization and critical vendor orders have based their arguments upon the statutory structure of priority for payment of unsecured claims. By definition, in both procedures, a debtor devotes unencumbered post-petition assets—which liquidation must divide equally among general unsecured creditors after the distribution of priority payments mandated by Section 507 of the Bankruptcy Code—to the reimbursement of a DIP financer's pre-petition unsecured claims. Because no section of the Code explicitly authorizes cross-collateralization or critical vendor payments, appellate courts have compellingly argued that they illegally circumvent the Section 507 priority scheme by decreasing the size of the asset pie available to general unsecured creditors in liquidation.

In contrast, other governance levers for which lenders and business debtors mutually bargain do *not* automatically shrink the amount of unencumbered value that may be apportioned among general unsecured creditors. Indeed, the text of the Bankruptcy Code does not endorse many provisions commonly enshrined in lending covenants, such as performance target schedules and the required appointment of a chief restructuring officer or new managers. Yet the Code does not outright *prohibit* such provisions, either. Moreover, whereas cross-collateralization and critical vendor orders obviously sidestep Section 507 priority rules, other mechanisms assuring DIP-lender control over corporate governance do not similarly counteract any enactments of the Bankruptcy Code. The innovative loan covenants of today have merely enabled financers, like any wily negotiator, rightfully to use their "bargaining position . . . to improve the status" of their claims.[136]

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[136] Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 702 (5th Cir. 1990). *See also* Baird & Rasmussen, *supra* note 130, at 23-24. Moreover, once a company reaches insolvency, its fiduciary duty shifts away from its shareholders to its creditors, so that

Judicial action to regulate loan covenants might attempt to solve problems that may not even exist. Some academics have disputed the hypothesis that restrictive governance levers result in inefficient liquidations of otherwise salvageable firms.[137] In fact, recent empirical studies have demonstrated that "debtors who obtain DIP financing are *more* likely to reorganize—not less—than debtors who don't."[138] Yet, even if future investigations should confirm DIP lenders' roles in forcing premature liquidation of truly viable firms, economic policy concerns alone, in the absence of a corresponding statutory violation, may not necessarily compel judicial intervention to curtail their control over the operations of corporate debtors. For example, sound business judgment may justify a decision to sell its assets or liquidate entirely, regardless of economic "efficiency." Under certain circumstances, management may act prudently by conceding governance to a more qualified workout specialist.

For a debtor in Chapter 11, the Bankruptcy Code establishes a process for the development, adoption, and implementation of a plan of reorganization. DIP lending agreements may effectively alter this process, however, by imposing additional or different contractual requirements. These requirements presumably advance the best interests of a secured lender, but they may also create an environment adverse to the best interests of creditors generally. Consider a DIP lending agreement which sets a strict timetable for the

they may realize their claims as fully as possible. For discussion of the fiduciary duty to creditors in insolvency, see, for example, C.R. Bowles & John Egan, *The Sale of the Century or a Fraud on Creditors? The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy*, 28 U. MEM. L. REV. 781 (1998); Marcia L. Goldstein & Scott E. Cohen, *Fiduciary Duties of Directors of an Insolvent Corporation*, SG108 ALI-ABA 193 (2002); Harvey R. Miller, *Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 SETON HALL L. REV. 1467 (1993); Robert B. Millner, *What Does It Mean for Directors of Financially Troubled Corporations to Have Fiduciary Duties to Creditors?*, 9 J. BANKR. L. & PRAC. 201 (2000).

[137] *See* Rasmussen, *supra* note 113, at 1937.

[138] Skeel, *supra* note 112, at 1925 (emphasis added).

submission of a disclosure statement and plan, and which requires conversion upon a default in that timetable. To the extent that the secured creditor is adequately collateralized, that secured creditor will derive no benefit from a delay in confirmation, and may therefore prefer a prompt liquidation. On the other hand, these standards may adversely impact the interests of unsecured creditors (and possibly also equity holders). From a procedural perspective, any timetable will restrict the ability of unsecured creditors to negotiate more favorable treatment for their claims. From a substantive perspective, the timing of confirmation may affect the eventual distribution. For example, the Bankruptcy Code requires that creditors "receive or retain" property of at least the same value that they would obtain upon liquidation under Chapter 7.[139] If creditors can reasonably expect a change of asset value, a delay in confirmation may require a material change in the Chapter 7 test.

Lending agreements may include terms that benefit secured creditors, but to the detriment of unsecured creditors. Thus, they entail a phenomenon like that which recently confronted Judge Eugene Wedoff in the bankruptcy proceedings for UAL Corporation, the parent of United Airlines. In a bench decision, Judge Wedoff refused to modify the labor agreements between the debtor and its pilots in any way that would adversely affect the rights of other union employees.[140] Similarly, with each DIP lending agreement, the court must consider whether an agreement beneficial to secured creditors nonetheless improperly harms the interests of other creditors or of equity holders.

Regardless of the normative reasons for or against strict DIP loan covenants, still "one has to be skeptical that much *can* be done to corral [them], either outside of bankruptcy or in."[141] The survival of cross-collateralization after *Saybrook*, and practitioners' continued support for critical vendor

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[139] 11 U.S.C. § 1129(a)(7) (2000).

[140] Micheline Maynard & Mary Williams Walsh, *Judge Rejects United's Contract with Pilots*, N.Y. TIMES, Jan. 8, 2005, at C1.

[141] *See* Baird & Rasmussen, *supra* note 130, at 32 (emphasis added).

orders despite *Kmart*, foreshadow two likely outcomes of judicial action to alleviate lenders' chokehold control over their debtors' governance. First, after overcoming their initial shock, bankruptcy specialists and DIP lenders could easily quarantine the impact of such a decision by requiring debtors to file for bankruptcy in forums that would nonetheless view control provisions favorably.[142] As Professor Skeel himself must admit, the role of commercial banks in DIP lending has grown so pervasive that it now represents a "genie" that "would be quite difficult to stuff . . . back in the bottle."[143] Consequently, one cannot expect the banks that have profited from DIP financing to accept meekly a bankruptcy or circuit court's attack on their mandatory conditions for lending. Just as DIP financers have continued to obtain cross-collateralization orders in the Southern District of New York and other courts outside the Eleventh Circuit, and as "critical" trade creditors will likely encourage Delaware corporations to file in Wilmington, these banks could refuse to lend to businesses who do not consent to seek bankruptcy protection in one of a number of a list of approved forums.

Alternatively, rather than forum-shop, commercial DIP financers may adapt to new, judicially-imposed lending regulations by creating new mechanisms, similar to the rollups popularized after *Saybrook*, that will enable them to take charge of a debtor's operations. If the courts would choose to regulate financing terms in bankruptcy, commercial lenders in response would likely "garner even greater control before bankruptcy is filed" by employing "greater use of prenegotiated plans, earlier replacement of directors not in sync with the creditor interest, and even greater use of [chief restructuring officers] with a reputation for safeguarding creditors' interests."[144] On account of DIP

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[142] For discussion of forum shopping in bankruptcy, see Marcus Cole, *"Delaware Is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845 (2002).

[143] Skeel, *supra* note 133, at 940.

[144] Baird & Rasmussen, *supra* note 130, at 41-42.

lenders' adaptability, many of the judicial solutions proposed by Professor Skeel, such as denying enforcement of specific terms of DIP covenants despite the mootness doctrine of Section 364(e), have proven unsuccessful in taming cross-collateralization and rollup financing.[145] Given this proven capacity to circumvent judicial efforts to curtail extrastatutory maneuvers commonly accepted in the trenches of bankruptcy practice, commercial lenders and supportive attorneys would surely develop new ways to assert control over the governance of insolvent debtors.

Notwithstanding the potential futility of efforts to restrict the use of loan covenants, debtors and secured lenders must carefully consider fiduciary obligations during their negotiations. Thus, in *Bush Industries*, the Bankruptcy Court denied confirmation of a plan whose terms satisfied a loan agreement that the debtor had negotiated in violation of its fiduciary duty to stock holders.[146] To the extent that they exercise domination and control over corporate decision making, secured lenders must similarly consider the potential for lender liability, by reason of any participation in violation of corporate fiduciary responsibility.

V. CONCLUSION

This survey piece has considered three DIP-financing incentives that currently rest at varying stages in their legal development. Cross-collateralization orders have survived their condemnation in *Saybrook* over ten years ago, thanks to the persistence of bankruptcy specialists in earning the indulgence of sympathetic courts to grant them as a vehicle for debtor rehabilitation, notwithstanding the text of the Bankruptcy Code. In contrast, *Kmart* only recently questioned the legal validity of critical vendor orders, whose prospects for endurance nonetheless remain bright on account of support from key federal courts, most notably in the Third Circuit. Meanwhile, the judiciary has not yet

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145 Skeel, *supra* note 133, at 940-41.

146 315 B.R. 292.

evaluated the propriety of lending covenants that grant a DIP financer control over the debtor's governance. Though such covenants represent a prominent concern among academics informed by economic conceptions of efficiency, they differ from cross-collateralization and critical vendor orders in their apparent acceptability under the language of the current Code. For this reason, and because of the ability of bankruptcy specialists to seek out jurisdictions that choose to permit such covenants, judicial efforts to remedy their impact in forcing premature liquidations shall likely prove ineffective.

Given these findings, what *can* be done about renegade financing incentives like cross-collateralization and critical vendor orders that contravene the text of the Bankruptcy Code? Moreover, if judges cannot eliminate economic inefficiencies triggered by restrictive lending terms, who can? Most likely, the answer to both of these questions lies in the American Constitution, which authorizes Congress "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[147] In a federal system in which businesses often may file for bankruptcy in one of a number of forums, Congress, as a collective actor in the scope of its rulemaking power, must enact legislative amendments that specifically address cross-collateralization, critical vendor orders, the role of lenders in corporate governance, and other DIP financing mechanisms that have arisen over the last twenty-five years. In the absence of such definitive Congressional action to create nationwide ground rules for lending to troubled businesses, Chapter 11 reorganization likely shall continue to feature financing practices that the Bankruptcy Code does not expressly endorse.

[147] U.S. CONST. art. I, § 8, cl. 4.