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Pandemic Hope for Chapter 11 Financing

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ABSTRACT. The pandemic revealed that the increasing complexity of debtor's capital structure could supply much-needed competition in the Chapter 11 financing market, as other *inside* lenders increasingly challenge a debtor's favored inside lenders. After discussing the benefits of this surprising development, the Essay identifies several impediments and offers strategies for removing them.

After Neiman Marcus, the luxury department store, filed for Chapter 11 in May 2020, two different groups of lenders vied to provide bankruptcy financing. Neiman's managers had arranged a $675 million lending package with a group of its first lien lenders prior to bankruptcy and requested approval for that group to provide the financing at the outset of the case.[1] Another investor group, which included Mudrick Capital Management and Third Point, quickly countered with a $700 million loan proposal.[2] The competing investors offered a lower interest rate and a different strategy for resolving Neiman's financial distress.[3]

1. *See, e.g.*, Mike Spector & Jessica DiNapoli, *Exclusive: Neiman Marcus Creditor Calls for Deal with Saks Fifth Avenue - Letter*, REUTERS (May 12, 2020, 8:50 PM), https://www.reuters.com/article/us-neinmanmarcus-m-a-saksfifthavenue-exc-idUSKBN22P035 [https://perma.cc/Y5B8-Q5KD].

2. *See* Objection to Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief at 1, *In re* Neiman Marcus Grp., No. 20-32519 (Bankr. S.D. Tex. May 7, 2020) [hereinafter Mudrick Objection], [https://perma.cc/XF6L-2UGF] (describing the counterproposal and objection by Mudrick Capital).

3. The Mudrick/Third Point proposal called for Neiman to solicit buyers and shift to a traditional Chapter 11 restructuring only if Neiman did not receive a credible offer during a nine-

Neiman's choice of lenders for its operations in bankruptcy was quite remarkable in two respects. First, Neiman had ready access to financing, as reflected in its receiving two different financing offers. The economy was shut down due to COVID-19, and there had been ominous signs in the financing market. Only a few weeks earlier, Sanchez Energy, a company already in bankruptcy at the outset of the pandemic, announced that it was unable to repay its bankruptcy loan.[4] Some commentators were warning that a crisis in the lending market might be imminent.[5] But Neiman had little trouble obtaining a sizeable new loan. Its financial advisor "acknowledged that the proposed [financing] is 'certainly unusual' in the sense that the debtors are obtaining financing despite the company largely not operating at the moment given the store closures amid the Covid-19 pandemic."[6]

Why was so much financing available to Neiman? In part because equity funds and other potential investors had an estimated $2.5 trillion of available funding (i.e., "dry power") at the outset of the crisis, due to a perceived dearth of attractive investment opportunities.[7] The unexpected buoyancy of the stock market also contributed. The large amount of federal money available under the CARES Act and other stimulus funding may have played a role, too, although that money could not be used for bankruptcy loans.[8]

ty-day auction period. *See, e.g.,* Neiman Marcus Group LLC $700 Million Superpriority Senior Secured Debtor in Possession Credit Facility Term Sheet exhibit A to annex I, *in* Mudrick Objection, *supra* note 3, at 37.(Neiman Marcus Group LLC $700 Million Superpriority Senior Secured Debtor in Possession Credit Facility Term Sheet) (milestone calling for final auction bids within 90 days).

4. *See* Andrew Scurria & Aisha Al-Muslim, *Bankruptcy Loans Turn Dangerous*, WALL ST. J. (Apr. 8, 2020, 8:03 AM), https://www.wsj.com/articles/bankruptcy-loans-turn-dangerous-11586347202 [https://perma.cc/Z67D-J72E].

5. *Id.*

6. *See Neiman Marcus Receives All Requested First Day Relief, Including Interim DIP Financing Approval over Objections from Mudrick, Marble Ridge, Others*, REORG (May 8, 2020, 8:37 PM), https://reorg.com/neiman-marcus-receives-all-requested-first-day-relief-including-interim-dip-financing-approval-over-objections-from-mudrick-marble-ridge-others [https://perma.cc/37Z2-29HD].

7. For discussion of this factor and those that follow, see Part I, *infra.*

8. The $500 billion lending program in the CARES Act that was designed for large businesses was linked to the Federal Reserve's emergency-lending power under section 13(3) of the Federal Reserve Act, which precludes loans to borrowers that are in bankruptcy. *See, e.g.*, David Skeel, *Bankruptcy and the Coronavirus: Part II*, BROOKINGS INST. 7 (July 2020), https://www.brookings.edu/research/bankruptcy-and-the-coronavirus-part-ii [https://perma.cc/G72B-HNWZ] (describing the limitation on borrowers in bankruptcy). The Paycheck Protection Program, which initially authorized up to $660 billion in loans to smaller businesses, did not explicitly prohibit loans in bankruptcy, but it was administered by the Small Business Administration, which does. *Id.*

The other remarkable feature of Neiman's access to financing was that two different bidders offered to provide the "debtor-in-possession" financing.[9] In most cases, a debtor has a single source of funding, usually from its principal prebankruptcy lenders.[10] The willingness of multiple lenders to provide DIP financing for Neiman may have stemmed in part from the confluence of the developments just described: large amounts of investable funds, a buoyant stock market, and the federal stimulus money.

But another, underappreciated factor also came into play: a striking shift in the capital structure of many corporate debtors. Capital structure is increasingly disaggregated.[11] Companies often borrow not just from one group of lenders—as with a syndicated loan in which a variety of lenders have stakes—but from multiple groups of diverse lenders, often under arrangements that give one group a first lien on the debtor's assets and the other a second lien.[12] RadioShack, in an early illustration of this trend, had two major groups of secured lenders, with an agreement between the two groups and separate agreements within each group.[13]

In this Essay, I argue that this trend could help solve a serious, longstanding problem in the market for DIP financing. In the past, the senior lenders of most corporate debtors were banks or a single syndicate of banks and other lenders.[14] Because of the information asymmetry between the debtor's princi-

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9. The term, which is quite nonintuitive to those who are not bankruptcy experts, comes from the fact that bankruptcy law deems the debtor and its managers to be a "debtor in possession"—that is, a debtor that has authority over its assets—when the debtor files for bankruptcy. *See* 11 U.S.C. § 1107 (2018) (providing the powers of a debtor in possession). If the debtor obtains financing for its operations in bankruptcy, the funds are thus debtor-in-possession (DIP) financing.

10. *See* B. Espen Eckbo, Kai Li & Wei Wang, *Rent Extraction by Super-Priority Lenders* 4 (Tuck Sch. of Bus., Working Paper No. 3384389, 2020) (citing evidence that 80% of bankruptcy financing comes from the debtor's current lenders); Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 655 n.13 (2020) (noting that in a sample data set of debtor-in-possession loans, 75% of bankruptcy financing came from debtors' current lenders).

11. *See generally* Kenneth Ayotte, *Why Do Bankrupt Firms Have Such Complex Capital Structures*, CLS BLUE SKY BLOG (Dec. 20, 2018), https://clsbluesky.law.columbia.edu/2018/12/20/why-do-bankrupt-firms-have-such-complex-capital-structures [https://perma.cc/6EMR-QF2F] (noting and speculating about possible reasons for the recent increase in capital-structure complexity).

12. For further discussion of first- and second-lien arrangements, see Section III.A, *infra*.

13. *See* Salus Cap. Partners, LLC v. Standard Wireless Inc. (*In re* RadioShack Corp.), 550 B.R. 700, 703 (Bankr. D. Del. 2016).

14. *See, e.g.*, Douglas R. Gooding & Jonathan D. Marshall, *Bankruptcy Is Uncharted Territory for Unitranche Lenders*, J. CORP. RENEWAL (Sept. 2018), https://turnaround.org/jcr/2018/09/bankruptcy-uncharted-territory-unitranche-lenders [https://perma.cc/M9AU-2G3M] pal lenders (who have more and better information about the debtor) and outside lenders (who have less and worse information), outside lenders are discouraged from competing to finance corporate debtors. The effects of the information asymmetry are magnified by a "debt overhang" problem: because some of the benefits of any new financing will accrue to the existing lenders, new lenders are unlikely to offer financing unless they are given priority over the existing lenders.[15] The vast majority—75% or 80%—of DIP loans come from the debtor's existing lenders, and these lenders consistently earn supracompetitive profits, which suggests that the obstacles to alternative financing are severe.[16]

Due to the fragmentation of firms' capital structures, many corporate debtors now have at least two groups of lenders, and sometimes more. Neiman Marcus, for example, had five different substantial groups of secured lenders.[17] Although the new capital structure complexity has potential downsides,[18] it also has a significant upside: it can provide a solution, or at least the beginning of a solution, to the lack of competition for DIP financing. Rather than outside lenders, a different source of alternative financing—other *inside* lenders, who do not face the same information asymmetries as outsiders—may challenge the favored insider lenders. Neiman's ready access to financing and choice between multiple potential lenders could become a much more common experience among corporations filing for Chapter 11. Even the possibility that an alternative bid may emerge could force a debtor's lenders to offer a more competitive rate for bankruptcy financing.

As the discussion above reflects, the descriptive and normative claims in this Essay draw on a rich literature about bankruptcy financing.[19] This Essay is the first to point out that the solution—or at the least, a partial solution—to

("When the Bankruptcy Code was enacted, the assets of a typical debtor were encumbered by a lien held by a single secured creditor.").

15. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149-55 (1977).

16. Eckbo et al., *supra* note 10, at 4 (80% of loans from insiders); *id.* at 28 (supracompetitive profits); Tung, *supra* note 10, at 655 n.13 (75% of loans from insiders).

17. *See infra* note 49 and accompanying text (noting that Neiman had five substantial groups of lenders and an additional $100 million loan).

18. Focusing on debt overhang rather than information asymmetries, Professors Ayotte and Ellias show that a first- and second-lien structure can discourage lower-priority creditors from competing with a DIP-financing offer from the first liens if the second-lien lenders are not permitted to receive a priming lien. Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. (forthcoming 2022) (manuscript at 23-32, 57-59), https://ssrn.com/abstract=3611350 [https://perma.cc/2FPL-86M8].

19. *See* Tung, *supra* note 10; Eckbo et al., *supra* note 10; Ayotte & Ellias, *supra* note 18. A key earlier contribution in a similar vein is Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 514 (2009).

these concerns may lie in plain sight: in the fragmentation of debtors' capital structures.

Unfortunately, three features of current bankruptcy practice may prevent this optimistic scenario from emerging. First, courts have been reluctant to grant nonconsensual "priming" liens—that is, liens that take priority even over the liens of existing lenders—which are needed to solve debt overhang problems.[20] Second, the intercreditor agreements that first and second lienholders enter into sometimes prohibit second lienholders from providing bankruptcy financing absent consent by the first liens, thus stymieing a potential alternative source of funding.[21] Finally, the debtor and key creditors often enter into a restructuring support agreement (RSA),[22] which may preclude any of the signatories from offering alternative financing. As a result, the RSA may preempt competition to provide financing.

It is important not to overstate the impediments. Even if courts continue on their current track, the number of competing DIP financing offers seems likely to increase. Although courts have been reluctant to award nonconsensual priming liens, the lucrative fees in this market are likely to entice other lenders in the capital stack of debtors with fragmented capital structures to challenge favored bids, putting pressure on courts to take these bids more seriously. By more carefully scrutinizing contractual provisions that interfere with competitive offers, or by amending bankruptcy law to encourage more competition, courts and lawmakers could spur even more competition.

This Essay proceeds in three Parts. Part I describes the surprising abundance of funding during the COVID-19 pandemic. In Part II, the focus turns to the striking shift in the capital structure of many corporations that later file for bankruptcy, and the potential for this shift to increase the competitiveness of the bankruptcy-financing market. Finally, Part III analyzes potential impediments to a more competitive market for bankruptcy financing and proposes potential correctives for each. Much of Part III is devoted to judicial scrutiny of the obstacles to a competitive lending market, but it also considers the possibility of amending bankruptcy law to address courts' reluctance to grant priming liens and loan provisions that stymie potential competing loans.

20. Priming liens, which are authorized by 11 U.S.C. § 364(d)(1) (2018), are discussed in Part II, *infra*.

21. This is discussed in detail in Section III.A, *infra*.

22. A restructuring support agreement (RSA) binds its signatories to the terms of a reorganization plan consistent with the terms they have negotiated. RSAs and their implications for financing are the focus of Section III.B, *infra*.

I. AN ABUNDANCE OF BANKRUPTCY FINANCING

When the COVID-19 crisis worsened in early 2020, causing the American economy to shut down, it seemed to augur a surge in Chapter 11 filings and a potential liquidity crisis as corporate debtors struggled to obtain bankruptcy financing.[23] During the Great Recession of 2008-2009, this is more or less what happened. In fall 2008, at the height of the crisis, access to bankruptcy financing evaporated for a few months, and corporate bankruptcies more than doubled.[24]

The COVID-19 pandemic had the potential to be even worse than the Great Recession, given the breadth of the economic shutdown. At first, the shutdown seemed to destabilize the DIP financing market. Sanchez Energy, which had filed for bankruptcy before the crisis, announced it would be unable to pay its bankruptcy loan.[25] The prospect of a default, an uncommon occurrence with DIP financing,[26] and uncertainty as to how long the economic shutdown would last pointed to the possibility of major turmoil in the financing market.

Yet turmoil never materialized. Since the pandemic began, large corporate debtors have had ready access to financing. The most remarkable example was Hertz, which considered financing its bankruptcy by selling stock after a surge of speculative trading significantly increased the stock price.[27] Were it not for the disapproval of the Securities and Exchange Commission, Hertz might not have needed a loan at all.[28] In the Neiman Marcus bankruptcy, two different

23. I was among those who warned of a potential wave. *See* David Skeel, *Bankruptcy and the Coronavirus*, BROOKINGS INST. (Apr. 21, 2020), https://www.brookings.edu/research/bankruptcy-and-the-coronavirus [https://perma.cc/3FLX-9DLJ]. A large group of bankruptcy scholars sprang into action early in the pandemic, forming working groups to propose responses to a bankruptcy wave. *See, e.g.*, Letter from Jared A. Ellias, Chair, Large Corp. Comm. of Bankr. & COVID-19 Working Grp., to Mitch McConnell, U.S. Sen., Chuck Schumer, U.S. Sen., Nancy Pelosi, U.S. Rep. & Kevin McCarthy, U.S. Rep. (June 10, 2020) (on file with author) (advocating for measures to expand the capacity of the bankruptcy system).

24. Business bankruptcy filings jumped from 28,322 in 2007 to 60,837 in 2009. The statistics are available at *Annual Business and Non-Business Filings by Year, 1980-2020*, AM. BANKR. INST., https://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy_Statistics/Total-Business-Consumer1980-Present.pdf [https://perma.cc/K7TK-U3ME].

25. *See* Scurria & Al-Muslim, *supra* note 4.

26. *Id.*

27. *See, e.g.*, Dan Runkevicius, *How Hertz Fooled Amateur Investors*, FORBES (July 1, 2020), https://www.forbes.com/sites/danrunkevicius/2020/07/01/how-hertz-htz-fooled-amateur-investors [https://perma.cc/79FW-FZMT].

28. *Id.*

groups of lenders competed to provide financing.[29] Overall, debtors obtained roughly $20.762 billion of DIP financing in 2020 amid the pandemic—over $5 billion more than debtors obtained in 2019.[30]

Why so much financing? One explanation is the estimated $2.5 trillion of "dry power" that distressed debt funds had at the outset of the pandemic.[31] With attractive investment opportunities scarce, funds had accumulated capital. Potential lenders were unusually well-positioned to make bankruptcy loans due to this quirk of the lending environment.

In addition to this private investment, the federal government pumped an enormous amount of federal money into the economy during the pandemic, both through legislative interventions such as the $2.1 trillion CARES Act, which directed funding to joint efforts of the Federal Reserve and Treasury, and through independent Federal Reserve programs.[32] Because these programs generally could not be used for bankruptcy loans,[33] federal money did not directly enhance access to DIP financing. Still, it appears to have increased liquidity for corporate debtors in indirect ways. For instance, the abundance of federal funds may have diminished funding opportunities for private lenders outside of bankruptcy, encouraging them to provide bankruptcy loans.

Like federal funding, the strength of the stock market throughout the pandemic may have also indirectly affected access to DIP financing. Many troubled corporate debtors appear to have been able to avoid bankruptcy altogether without borrowing money due to the ease of raising capital by selling stock.[34] AMC Theatres is a vivid illustration. Though it was an obvious candidate for Chapter 11 early in the pandemic, it proceeded to raise $1.2 billion through eq-

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29. See Parts II and III, *infra*, for a detailed discussion of the Neiman Marcus bids.

30. My thanks to David Smith for these numbers, which he compiled from information in the Deal database. *See* Email from David C. Smith, Professor of Com., Univ. of Virginia, to David Skeel, Professor of Corp. L., Univ. of Pennsylvania (June 7, 2021, 2:37 PM) (on file with author).

31. The $2.5 trillion number comes from Edith Hotchkiss, Greg Nini & David C. Smith, Corporate Capital Raising During the COVID Crisis 9 (Nov. 1, 2020) (unpublished manuscript) (on file with author). Eliot Ganz and David Smith had noted early in the pandemic that there was an unusual amount of funding available for companies experiencing bankruptcy. Elliot Ganz & David Smith, *It's Not Time for a Government Bankruptcy Facility*, REALCLEAR MTS. (June 15, 2020), https://www.realclearmarkets.com/articles/2020/06/15/its_not_time_for_a_government_bankruptcy_facility_496152.html [https://perma.cc/22LW-ZV2G].

32. For a discussion of federal-economic stimulus provided through the CARES Act and the Paycheck Protection Program, see note 8, *supra*.

33. *Id.*

34. *See, e.g.*, Emily Flitter, Matt Phillips & Peter Eavis, *How the Stock Market's Relentless Rise Saved Companies*, N.Y. TIMES (Feb. 4, 2021), https://www.nytimes.com/2021/02/01/business/stock-market-banks.html [https://perma.cc/7W4M-MNUC].

uity issuances in a single quarter.[35] In addition to indirectly boosting the DIP financing market by diminishing lending opportunities outside of bankruptcy, stock-market strength directly contributed to the robust market for the new stock of corporate debtors when they exited bankruptcy.[36]

Finally, another less obvious factor enhanced access to DIP financing: the increased complexity of corporate debtors' capital structure due to first- and second-lien arrangements and other new financing structures, as discussed earlier and in more detail in the next Part. Compared to the $2.5 trillion in available funding and the massive amounts of federal aid, this capital-structure shift is less dramatic and was perhaps less important during the pandemic.[37] But as I argue in Part II below, the new capital structure has major implications for the future of Chapter 11.

II. THE NEW CAPITAL STRUCTURE: MULTIPLE INSIDE LENDERS

When the Bankruptcy Code was enacted in 1978, the bankruptcy-financing provision was one of its key innovations.[38] The provision sharply expanded debtors' ability to obtain financing by empowering bankruptcy judges to provide sweeping protections for lenders who agree to finance debtors' operations in bankruptcy—including a "priming lien" that has priority even over existing secured creditors.[39]

If DIP financing functioned like the competitive markets taught in Economics 101, early entrants into the market would have made supracompetitive

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35. Matt Phillips, *AMC Cashes in on Meme Stock Mania, Raising $587 Million*, N.Y. TIMES (June 3, 2021), https://www.nytimes.com/2021/06/03/business/amc-meme-stock.html [https://perma.cc/U9A9-WEZ7].

36. *See, e.g.*, Ciara Linnane, *Bankrupt Hertz' Stock Soars 62% on News of Deal to Exit Chapter 11 that Will Benefit Shareholders*, MARKETWATCH (May 13, 2021, 2:48 PM ET), https://www.marketwatch.com/story/bankrupt-hertz-shares-soar-62-on-news-of-deal-to-exit-chapter-11-that-will-benefit-shareholders-11620845287 [https://perma.cc/2DTS-8UDT] (describing plans for the sale of newly issued Hertz stock in connection with its reorganization).

37. *See* discussion *supra* note 30 and *infra* Part II.

38. For a historical overview, see David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004).

39. *See* 11 U.S.C. § 364 (2018). If unsecured financing is not available, the lender can be given an administrative priority, which is a claim that generally must be paid in full in cash at the end of the case. *See id.* § 1129(a)(9). Alternatively, or in addition to administrative priority, the lender can be given a lien on some or all of the debtor's assets. The final and most dramatic option is a "priming" lien with priority even over existing liens if existing lienholder's interests are "adequately protected." As discussed at the end of this Part and the beginning of Part III, the bankruptcy court's priming-lien authority will be essential to fostering a more competitive DIP financing market.

profits, which would have declined as the market matured. But this did not prove to be the case. Recent evidence suggests that DIP lenders continue to make extraordinary profits. One study, for example, found that lenders charge several percentage points higher than a competitive interest rate.[40] Another concluded that DIP loans are priced similarly to junk debt, despite being far less risky.[41]

The key to understanding the stickiness of DIP lenders' supracompetitive profits lies in another feature of the market: 75% or more of DIP loans are made by the debtor's current lender.[42] The dominance of insider lenders stems from two factors that discourage competition. The first is information asymmetries. Because a debtor's existing lender has better information about the debtor, it is difficult for a new lender to compete.[43] Second, the inside lender often has a lien on all the debtor's assets; one study found that 75% of bankruptcy debtors obtain senior secured financing before bankruptcy and the loans are secured by all of the debtor's assets 97% of the time.[44] Unless the court grants a priming lien, a new lender's loan may subsidize the existing lender at the expense of the new lender, since the existing lender has the first claim on any value created. This effect—debt overhang—may further discourage new entrants.[45]

If the debtor has a single lender or syndicate of lenders, the obstacles to obtaining financing from any lender other than the current lender may be insurmountable. If the debtor's existing lender has offered to provide new financing, a new entrant will be competing with a lender that has better information and an existing relationship with the debtor, and it may suspect that the debtor will be reluctant to take a chance on a new lender. Even if the existing lender declines to supply additional funding, a new entrant may still be reluctant to offer financing, given the adverse signal sent by the current lender's refusal to make another loan.

With current corporate debtors, however, the traditional pattern of a single lender or syndicate of lenders often does not apply. A debtor's financing is much more likely to be fragmented.[46] A key development has been the in-

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40. Eckbo et al., *supra* note 10, at 28-29 (supracompetitive profits).

41. Tung, *supra* note 10, at 686 (comparable to junk bonds).

42. Eckbo et al., *supra* note 10, at 41 (80%); Tung, *supra* note 10, at 655 n.13 (75%).

43. *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. Chi. L. Rev. 1557, 1579-85 (2013) (discussing information asymmetry (or "adverse selection") issues).

44. Ayotte & Morrison, *supra* note 19, at 513-14.

45. *See* Myers, *supra* note 15, at 149-55.

46. For a similar point, see Gooding & Marshall, *supra* note 14.

creased use of first- and second-lien arrangements in which a group of lenders holds a first lien on the debtor's assets and another group holds a second-priority lien.[47] The first and second lienholders often enter into an "intercreditor" agreement that specifies their rights vis-à-vis one another. Less common but somewhat similar are "unintranche" arrangements, which have a similar priority arrangement but are framed as single loan rather than separate first lien and second loans.[48] Some corporate debtors have even more groups of senior lenders. Neiman Marcus had five separate collateralized loans ranging from $561.7 million to $2,253.1 million at the time of bankruptcy, including both second- and third-lien loans.[49] Each group may itself be comprised of a variety of lenders, ranging from distressed debt funds to traditional commercial banks.

This fragmentation of corporate debtors' borrowing can have problematic effects. Intercreditor agreements among the parties,[50] or the lien structure itself,[51] can interfere with an efficient restructuring process. But the fragmentation also has an important and underappreciated potential upside: it ensures that the debtor has multiple inside lenders, rather than just one. This creates the possibility of lending competition from within the debtor's capital structure. The shift in debtors' capital structure suggests that improved competition and a more efficient lending market actually may come not by encouraging outside lenders to provide DIP financing, as one might assume; it may come from other *inside* lenders instead.

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47. An early discussion of second liens marveled at the "exponential increase in the number of second lien financings in the senior bank loan market." Neil Cummings & Kirk A. Davenport, *A Primer on Second Lien Term Loan Financings*, 2004 COM. LENDING REV. 11.

48. For a discussion of unitranche loans, see Gooding & Marshall, *supra* note 14; and Andrew Hedlund, *Rise in Private Credit Leads to Boost in Unitranche Loans*, REUTERS (Feb. 19, 2020, 2:46 PM), https://www.reuters.com/article/unitranche-size/rise-in-private-credit-leads-to-boost-in-unitranche-loans-idUSL1N2AJ15Q [https://perma.cc/VDN9-W8C9] ("Seven unitranches of at least US$1bn have been extended in 2019 and the opening months of 2020, according to Refinitiv LPC data.").

49. It also had a smaller, $100 million secured loan. *See, e.g.*, Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief at 22, *In re* Neiman Marcus Grp., No. 20-32519 (Bankr. S.D. Tex. May 7, 2020) [hereinafter Neiman Marcus DIP Financing Motion] (listing Neiman's obligations).

50. The intercreditor agreements entered into between first-lien and second-lien creditors may create externalities, for instance, or have the effect of silencing a key constituency. *See* Kenneth Ayotte, Anthony J. Casey & David A. Skeel, Jr., *Bankruptcy on the Side*, 112 NW. U. L. REV. 255, 284-86 (2017).

51. *See* Ayotte & Ellias, *supra* note 18, at 23-32 (describing the possibility that second lienholders may not offer financing in the absence of a priming lien).

The Nieman Marcus bankruptcy illustrates the potential pattern. When Nieman filed for bankruptcy, it had arranged for $600 million of new financing from a group of existing lenders, including Pacific Investment Management Co., Davidson Kempner Capital Management LP, and TPG's Sixth Street Partners.[52] An investor group that comprised investment firm Mudrick Capital Management LP and Third Point LLC countered with an offer to lend $700 million at a lower interest rate and significantly lower fees than the favored lenders' loan.[53]

Mudrick Capital was not a random outside lender that saw Neiman Marcus as an attractive lending opportunity. To the contrary, Mudrick Capital already had a stake in Neiman Marcus, holding $144 million of its first-lien loans.[54] Mudrick was thus an inside lender. Prior to Neiman's bankruptcy, Mudrick had pressed its managers to pursue a sale or merger with Saks Fifth Avenue.[55] Mudrick's proposed loan reflected its vision for Neiman's future. A key condition of the competing proposal was that Neiman Marcus would be required to first seek a sale of its assets, before attempting to reorganize its finances and operations. If no credible bidder emerged, Neiman Marcus could try to achieve a traditional reorganization.[56]

Neiman and its preferred lenders fended off the Mudrick threat by appealing to courts' traditional reluctance to protect a new lender with a priming lien.[57] Neiman argued that it would not be possible to provide adequate protection of the preferred lenders' liens, which the DIP financing provision requires as a prerequisite for approving a priming lien. According to Neiman's principal bankruptcy lawyer, a "non-consensual priming fight is not a fight that we could win."[58] Neiman's and its lawyer's not-so-subtle point was that, because Neiman and the favored lenders had no intention of agreeing to a priming lien giving

52. *See, e.g.*, Mike Spector, Svea Herbst-Bayliss & Jessica DiNapoli, *Exclusive: Investors to Challenge Neiman Marcus Bankruptcy Loan, Push for Sale - Sources*, Reuters (Apr. 26, 2020, 10:06 PM), https://www.reuters.com/article/us-neimanmarcus-bankruptcy-exclusive-idCAKCN22905E [https://perma.cc/US8M-56CH].

53. Mudrick's loan would have been at 11% interest, and it vowed to charge one-half the backstop fees of the favored lenders' loan. *See* Mudrick Objection, *supra* note 2, at 10-11.

54. *Id.* at 1.

55. *See* Spector & DiNapoli, *supra* note 1.

56. Mudrick Objection, *supra* note 2, at 10. Under Mudrick's $700 million proposal, $100 million would be set aside to pay some of Neiman's existing lenders. *Id.*

57. Consistent with the conventional wisdom, Ayotte and Morrison found that "80 percent of priming liens involve the DIP lender priming itself," and their data did not reveal what portion of the rest involved consensual priming liens. Ayotte & Morrison, *supra* note 19, at 525.

58. *See* Reorg, *supra* note 6 (quoting comments of Chad Husnick of Kirkland & Ellis at the First Day Orders hearing).

Mudrick priority over their liens, the Mudrick bid could not be approved unless the court conducted a valuation hearing to determine whether Neiman's assets were sufficient to ensure payment of the favored lenders despite their subordination to a new priming lien; any effort to demonstrate "adequate protection" would fail, they claimed. This seems to have been sufficient to dissuade the court from seriously considering the Mudrick alternative. Although the court described the preferred lenders' loan as "expensive money" and mused that "[w]e all wish that Neiman Marcus could get a [Paycheck Protection Program] loan and that it would be free," it rejected Mudrick's challenge and approved the preferred loan.[59]

As the Neiman battle reflects, genuine competition in the DIP lending market will depend on courts' willingness to grant nonconsensual priming liens in appropriate cases. Given that corporate debtors invariably have few unencumbered assets, alternative lenders face debt overhang issues and priming liens will often be essential.[60] One reason for optimism that bankruptcy courts will indeed show more willingness to grant priming liens if an increasing number of alternative-financing offers emerge from within debtors' capital stack is that the presence of a concrete alternative offer reduces the risk of a disastrous outcome if the court denies the favored lenders' proposal. When debtors and their preferred lenders ask the court to approve a DIP financing proposal at the outset of the case, they often claim that the debtor is desperate for cash and will collapse if a proposed loan is not approved; in the absence of an alternative source of funds, bankruptcy judges are understandably reluctant to call their bluff.[61] The threat is much less credible if an alternative lender has offered to provide funding.

Of course, inside lenders are not all similarly situated. A distressed-debt investor that has recently acquired a portion of a senior or junior loan will have less of an information advantage than a single bank that has been a firm's longtime lender and provides all of the debtor's banking services. This difference in status may be reflected in the terms of the loans the new insiders offer. A newly arrived distressed-debt investor may be more likely to seek to impose strict limitations on the debtor's options in bankruptcy, for instance, to minimize the

59. *Id.*

60. Other commentators also have emphasized the need for greater access to priming liens. *See, e.g.*, Ayotte & Ellias, *supra* note 18, at 57-59 (advocating for blanket use of two-to-three month priming liens).

61. *See generally* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 882-83 (2014) (describing the difficulty and rarity of challenging proposed bankruptcy sales supported by just enough DIP financing to fund the sale process).

risk of the loan.[62] The new lender may also be more willing to provide exit financing—that is, new financing for the debtor as it emerges from bankruptcy—given that it will have the benefit of all the information produced by the bankruptcy case when it offers to make an exit loan (assuming the exit financing offer is made during or at the end of the case, rather than at the outset).

To be sure, increased competitiveness in the DIP financing market would bring costs as well as benefits. If a debtor's relational bank or other senior lenders anticipate competition from other lenders if the debtor files for bankruptcy, this may affect their behavior prior to bankruptcy. For instance, they may be quicker to insist that the debtor put a chief restructuring officer in place to protect their interests. Lenders might also impose a higher interest rate to offset the loss of potential DIP financing profits. Although the prospect of bankruptcy lending competition is probably not salient enough to affect loans to financially healthy debtors, it might impact struggling debtors.

Despite these potential costs, genuine competition in the DIP financing market would almost certainly improve the efficiency of the bankruptcy process. In addition to the burden of paying supracompetitive interest rates, the risk that favored lenders and a debtor's managers will make deals that benefit one or both at the expense of the company and its other constituencies is quite high when the company falls into financial distress.[63] A competitive financing market would help to address both concerns. A momentous unintended consequence of the increased complexity of corporate debtors' capital structure is that it makes financing market competition much more likely.

III. IMPEDIMENTS TO COMPETITIVE FINANCING

The story this Essay has told thus far is an optimistic one. Bankruptcy financing was far more abundant during the pandemic than expected. Moreover, the shift in debtors' capital structure suggests that DIP financing will be more competitive after the pandemic than it was before, at least among firms with fragmented capital structures.

The most obvious impediment to a more competitive lending market is courts' reluctance to grant nonconsensual priming liens. Unlike the consensual

62. Note that Mudrick's proposed DIP financing for Neiman Marcus had this quality. It would have required that Neiman attempt to quickly sell its assets, likely to Saks Fifth Avenue. *See supra* note 3 (describing the ninety-day timeline for an auction); Spector & DiNapoli, *supra* note 1 (describing Mudrick's call for Neiman to consider a sale to Saks). But the preferred loan in *Neiman* also circumscribed the debtor's options.

63. Ayotte and Ellias consider, among other things, the possibility that current lenders may use their DIP loans to protect against fraudulent conveyance or preference challenges. Ayotte & Ellias, *supra* note 18, at 32-37.

priming liens a debtor's existing lenders often give to themselves—with a new DIP loan priming their prebankruptcy loan—a nonconsensual loan requires a bankruptcy judge to determine at a valuation hearing that the earlier loan will be adequately protected. A thawing of this reluctance is essential to the emergence of a competitive lending market, given the debt-overhang issues that discourage new lenders from making loans without an assurance of priority. As discussed in the last Part, there are grounds for cautious optimism that this thawing could in fact occur.[64]

But two additional impediments could interfere with the emergence of a more competitive DIP financing market. First, intercreditor agreements sometimes contain provisions that explicitly preclude potential lenders from making bankruptcy loans. Second, the restructuring support agreements that have become a key feature of many Chapter 11 cases may indirectly achieve the same preclusive effect, by committing potential lenders to a reorganization strategy that incorporates the preferred lenders' DIP loan. In this Part, I discuss these impediments and propose solutions for each.

A. *Explicit Restrictions on Financing*

When a corporate debtor borrows under a first- and second-lien financing arrangement, the first and second lienholders often use an intercreditor agreement to allocate their rights vis-à-vis one another. One standard term gives first lienholders the exclusive right to enforce the parties' rights in their collateral.[65] More aggressive restrictions may preclude the second liens from objecting to a reorganization plan supported by the first liens or may prohibit the second liens from providing DIP financing absent consent from the first lienholders.[66]

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64. *See supra* text accompanying notes 60-61. The problem also could be addressed legislatively. To increase judges' willingness to grant priming liens, for instance, the bankruptcy-financing provision could be amended to require that the bankruptcy court hear preliminary evidence about the value of the company's assets and the scope of the favored lender's liens before rejecting an alternative-financing proposal that offers better terms than the favored loan. This would diminish the force of claims by the debtor that the court can avoid valuation issues by simply approving the favored loan.

65. *See infra* note 67 and accompanying text (discussing this provision in the context of *In re* MPM Silicones, LLC (*Momentive*), 518 B.R. 740 (Bankr. S.D.N.Y. 2014)).

66. The American Bar Association's Model First Lien/Second Lien Intercreditor Agreement includes a "compromise" provision, which prohibits the second lienholders from offering DIP financing secured by liens equal or superior to the first lienholders' liens unless the first lienholders have not offered to provide DIP financing. Comm. on Com. Fin., Am. Bar Ass'n Section of Bus. L., *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force*, 65 BUS. L. 809, 857 (2010) ("No Second Lien Claimholder may provide DIP Financing to a Borrower or other Grantor secured by Liens equal or senior in priority to the Liens securing any First Lien Obligations[], *provided* that if no First Lien Claimholder offers to

The last of these provisions—the loan prohibition—is of concern here. It is not difficult to see why first lienholders might wish to have such a provision. Much as the second lienholders could undercut the first liens by objecting to a reorganization plan favored by the first liens, or by supporting a plan opposed by the first liens,[67] providing financing also could interfere with the first lienholders' objectives. A loan from the second liens could prolong the case at a time when the first lienholders want to force a sale or other quick resolution.

If the second lienholders are trying to prolong the case and divert value from the first lienholders, a loan prohibition might be justifiable. But the risk that a DIP loan will be used to divert value does not seem great. Offering to make a DIP loan would be a cumbersome way to divert value, given that it requires a substantial new investment from the second lienholders. To be sure, the investment would be compensated, but it is a substantial upfront expenditure nonetheless. Moreover, it seems more likely that a loan prohibition will be used to divert value from other creditors to the first lienholders than it is that a loan from the second lienholders will divert value from the first liens. Of particular importance for present purposes, the uncertain benefits of the loan prohibition come at the cost of cutting off one of the most promising potential sources—perhaps the most promising source—of alternative funding.

Loan prohibitions can be analogized to two other provisions that limit a debtor's options in Chapter 11: prebankruptcy stay waivers and ipso facto clauses. Stay waivers are usually negotiated by a debtor and its lender as part of an out-of-court workout of a loan; in return for the lender's forbearance, the debtor agrees not to oppose a motion to lift the stay if the debtor subsequently files for bankruptcy.[68] An ipso facto clause makes the debtor's insolvency or bankruptcy an event of default under a contract.[69] Courts are skeptical of stay waivers, but sometimes enforce them if other creditors have notice of their pro-

provide DIP Financing to the extent permitted under section 6.1(a) on or before the date of the hearing to approve DIP Financing, then a Second Lien Claimholder may seek to provide such DIP Financing secured by Liens equal or senior in priority to the Liens securing any First Lien Obligations, and First Lien Claimholders may object thereto[].").

67. A battle between the senior and junior liens in the *Momentive* case centered on the question whether the junior liens' support for a plan opposed by the senior liens violated the parties' intercreditor agreement. Judge Drain sided with the junior liens, concluding that the agreement only gave the senior liens control over the collateral, and did not limit the junior liens' right to take contrary positions on issues that did not directly implicate the collateral. *In re MPM Silicones*, 518 B.R. at 751-52.

68. *See* Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 304 (1997); James T. Marcus & John F. Young, *Enforcement of Pre-Petition Waivers of the Automatic Stay*, 26 COLO. LAW. 47, 47 (1997).

69. *See, e.g.*, Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 454-55 (1999) (criticizing the Bankruptcy Code's invalidation of ipso facto clauses).

visions.[70] Ipso facto clauses are invalidated by several provisions of the Bankruptcy Code.[71]

Although the consequences of a loan prohibition are less severe than with a stay waiver, loan prohibitions actually are more problematic. The context where courts have tended to uphold prebankruptcy stay waivers is small businesses whose lender has a security interest in all of the debtor's assets.[72] A large majority of small businesses are not viable when they file for Chapter 11 and end up liquidating, with most or all of the value of the business going to the principal lender if there is one and little recovery for other creditors.[73] Waiving the stay so that the lender is able to foreclose on the debtor's assets therefore is not likely to impose externalities on other creditors, and courts generally do not enforce waivers if other creditors will be harmed.[74]

Loan prohibitions are more similar to ipso facto clauses in this regard than to the stay waivers that courts generally enforce. An ipso facto clause may deprive the debtor of a contractual relationship or of the financing it needs to efficiently resolve its financial distress. Loan prohibitions in intercreditor agreements impede financing in similar fashion. Each undermines the purpose of Chapter 11, which is to provide a collective forum that enables the parties to preserve the going-concern value of a business if the business is viable when the debtor files for bankruptcy.[75] A stay waiver that does not affect the interests of creditors other than the debtor's principal lenders does not raise the same concerns.

70. Tracht, *supra* note 68, at 311-13.

71. 11 U.S.C. §§ 365(e), 541(c)(1)(B) (2018).

72. *See* Tracht, *supra* note 68, at 312 ("Nearly all of the published cases on contractual waivers of specific bankruptcy rights address waivers of the automatic stay granted to a secured creditor during a prepetition workout."). *See generally* Mark A. Cody & Mark G. Douglas, *A Brief Guide to Automatic Stay Waivers, Bankruptcy Remoteness, and Bad Boy Guarantees*, JONES DAY (July/Aug. 2016), https://www.jonesday.com/en/insights/2016/08/a-brief-guide-to-automatic-stay-waivers-bankruptcy-remoteness-and-bad-boy-guarantees [https://perma.cc/9JWS-HRXP] (providing background on automatic-stay waivers).

73. *See* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2330-40 (2005) (demonstrating that typical Chapter 11 debtors are small businesses whose businesses are not viable when they file for bankruptcy).

74. *See, e.g.*, Cody & Douglas, *supra* note 72 (noting "whether other parties are affected" as a factor that courts consider in determining whether to enforce a stay waiver).

75. The classic exposition is THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

The same point can be made another way: liquidity is essential to the reorganization process;[76] contractual provisions that interfere with a debtor's ability to obtain new financing are thus inherently suspect. Given the conflict between loan prohibitions and the purpose of Chapter 11, a statutory prohibition is justified. Indeed, I have argued elsewhere that a provision in current law that precludes debtors from invoking prebankruptcy commitments by a lender to extend credit should be repealed.[77] Making both of these adjustments would have a salutary effect on access to financing in bankruptcy.

Even in the absence of legislative reform, bankruptcy judges could address the problem by refusing to enforce loan prohibitions in most or all cases. Courts should override the provisions unless there is clear evidence the loan would be used to divert value from the first lienholders or other lenders that invoke the prohibition.[78]

B. The Chilling Effect of Restructuring Support Agreements

The second impediment to a competitive DIP financing market is more subtle and difficult to police. In many current bankruptcies, the parties enter into RSAs with key creditors before filing for bankruptcy.[79] The RSA commits its signatories to support a reorganization plan consistent with the terms outlined in the RSA.[80] RSAs provide a variety of important benefits, such as enhancing coordination among the debtor and its creditors by committing the signatories to requiring that anyone who buys a claim from them also honor the RSA. Absent an RSA, a deal that had been carefully negotiated might fall apart if enough of the signatories sold their claims to other investors.[81]

Although often beneficial, RSAs sometimes have problematic features. They may be unjustifiably coercive, for instance, or give excessive fees to fa-

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76. For a discussion of the importance of liquidity and features of bankruptcy law that increase access to liquidity, see Ayotte & Skeel, *supra* note 43; George G. Triantis, *Financial Slack Policy and the Laws of Secured Transactions*, 29 J. LEG. STUD. 35, 66 (2000).

77. *Id.* at 1608-09.

78. This approach would, in a sense, be similar to courts' treatment of stay waivers, though with a stronger presumption against enforcement.

79. If the agreement is entered into during bankruptcy rather than before the filing, it is often called a plan support agreement (PSA) rather than an RSA. RSAs and PSAs are described in detail in David A. Skeel Jr., *Distorted Choice in Corporate Bankruptcy*, 130 YALE L.J. 366, 378-81 (2020).

80. *Id.* at 370.

81. *Id.* at 385 (discussing the significance of this risk given the extensive amount of claims trading in current cases).

vored parties.[82] Another feature of many RSAs is of particular concern here. Like the loan prohibitions discussed in the last section, an RSA may preclude potential lenders from offering bankruptcy financing. At first glance, one might doubt that a potential lender would sign an RSA if the lender would lose the opportunity to make a profitable loan as a result. But RSAs often give signing fees to their signatories;[83] the prospect of receiving a signing fee may therefore persuade the lender to forgo offering alternative financing.

The favored insider financing in Neiman Marcus was linked to an RSA in precisely this way. As Neiman's financial advisor put it in his declaration supporting the financing request, the DIP financing agreement, the RSA, and a related agreement were "integrated and intertwined."[84] Lenders who wished to participate in the $675 million DIP financing were required to sign the RSA,[85] which dictated the path of the Chapter 11 case, committing the parties to a prompt recapitalization that would give control to the lender groups that provided the DIP financing. Signatories of the RSA would receive lucrative fees for agreeing to "backstop"—that is, to purchase any portion of a planned loan or issuance of stock that the debtor is unable to find investors for—the DIP financing and $75 million in additional financing when Neiman exited Chapter 11.[86]

The RSA and DIP financing arrangement created two major impediments to alternative insider-financing offers. First, the preferred lenders minimized the risk of competition by locking up the vast majority of Neiman's current

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82. These concerns are discussed in detail in *id.* at 395-405, which offers rules of thumb to courts for scrutinizing RSAs.

83. *Id.* at 398-99.

84. The other related agreement was an Exit Facility. Declaration of Tyler W. Cowan in Support of the Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief at 10, *In re* Neiman Marcus Grp., No. 20-32519 (Bankr. S.D. Tex. May 7, 2020) [hereinafter Cowan Declaration].

85. *See, e.g.*, Superpriority Senior Secured Debtor-In-Possession Term Loan Credit Facility Backstop Commitment Letter 2 (May 7, 2020), *in* Neiman Marcus DIP Financing Motion, *supra* note 49, at 308, 309.

86. "The Restructuring Support Agreement provides commitments from the Term Loan Lender Group . . . and the Noteholder Group to backstop the proposed $675 million new-money debtor in possession financing facility (the 'DIP Facility'), provide a $750 million exit financing facility (the 'Exit Facility'), and support implementation of [the proposed] chapter 11 plan . . . . Importantly, the DIP Lenders have agreed to provide the Prepetition Term Loan Lenders, the holders of the Second Lien Notes, the holders of the 2028 Debentures, and the holders of the Third Lien Notes with an opportunity to participate in the DIP Facility and Exit Facility if they sign the Restructuring Support Agreement." Neiman Marcus DIP Financing Motion, *supra* note 49, at 3-4.

lenders. Of the three principal lender groups, 78% of the first, 99% of the second, and 70% of the third were signatories of the RSA and thus could not offer alternative financing.[87] This significantly reduced the number of inside lenders that could plausibly bid against the preferred financing offer.

Second, and related, an inside lender that wished to make an alternative-financing offer would be forced to forgo the lucrative backstopping fees. The form of the fees implicitly precluded an inside lender from both signing the RSA and making an alternative-financing offer, since signatories to the RSA received their compensation in the form of fees for backstopping the preferred financing. If the RSA offered cash fees to signatories, by contrast, it would be logically possible both to participate in the RSA and to offer alternative financing. But this distinction ultimately makes little difference: either way, the RSA had multiple terms that would be violated if a signatory sought to provide alternative financing. RSA signatories were required to "support the Restructuring Transactions,"[88] and were not permitted to "object to, delay, impede, or take any other action to interfere with acceptance, implementation, or consummation of the Restructuring Transactions," or to "propose, file, support, or vote for any Alternative Restructuring Proposal."[89] Lenders that signed the RSA thus gave up the right to offer alternative financing.

Given these impediments to challenging the favored inside DIP financing proposal, it is quite surprising that a competing bid nevertheless emerged. Mudrick appears to have been excluded from the negotiations on the preferred financing.[90] Neiman and the preferred lenders may have assumed that the large percentage of lenders included in the favored bid would discourage competitors.

In its response to the Mudrick offer, Neiman emphasized the fact that the Mudrick lenders held only a minority of the major existing debt—not enough to control a vote of the existing lenders whether to agree to a priming lien for Mudrick's alternative financing—and that the proposal would therefore require a nonconsensual priming of the existing lenders. "[T]he Debtors received a

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87. *Id.* at 3.

88. Declaration of Mark Weinstein, Chief Restructuring Officer of Neiman Marcus Group Ltd LLL, in Support of the Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief at 15 app. B § 4.01(a)(i), *In re Neiman Marcus Grp.*, No. 20-32519 (May 7, 2020) [hereinafter Neiman RSA].

89. *Id.* at 16.

90. *See* Mudrick Objection, *supra* note 2, at 8-9 (describing Mudrick's exclusion and efforts to participate).

competing proposal from a group of term loan lenders [i.e., the Mudrick group] that did not collectively hold greater than 50% of outstanding term loans, the requisite amount to achieve consent under the Term Loan Facility," according to Neiman's financial advisor.[91] "As a result, the proposal would have required nonconsensual priming of existing term loan lenders with little to no remaining unencumbered collateral to offer to primed term loan lenders as adequate protection."[92]

Neiman Marcus would have been a good opportunity for a court to grant a nonconsensual priming lien, or at the least to have given it more serious consideration. The willingness of the existing lenders to provide $675 million of new financing secured by their existing liens suggests that Neiman's assets were valuable enough to support significant new lending. Perhaps the Mudrick proposal was too flawed, but it was significantly cheaper. The court could have devoted a hearing specifically to the question of whether Neiman's assets were sufficient to assure adequate protection of the existing lenders in the context of a priming lien.

The Neiman experience also suggests that courts should scrutinize RSAs that are linked to DIP financing especially closely if they are likely to discourage competing loans from within the capital stack.[93] Because it locked up substantial majorities of the current lenders, the Neiman RSA was particularly suspect. In its objection, Mudrick stridently insisted that the backstop fees bore no relation to any value the backstoppers were providing, because there was little risk the backstop would be needed and the fee would be paid in steeply discounted stock.[94] If this is correct, the court should have balked at the fees.[95] Policing ex-

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91. Cowan Declaration, *supra* note 84, at 11.

92. *Id.* Neiman sounded the same themes in its motion for approval of the financing. *See* Neiman Marcus DIP Financing Motion, *supra* note 49, at 5 ("[T]he proposal required a protracted, costly, and difficult priming fight at the outset of these chapter 11 cases with little chance at success when the Debtors should be focused on stabilizing their operations and building further consensus . . . ."); *id.* at 32 (similar language); *id.* at 35-36 (similar language).

93. In a recent article on RSAs, I noted this issue but did not directly address it. Skeel, *supra* note 79, at 371 n.15. This Essay extends the analysis of that article.

94. The backstop fees were paid in newly issued stock of the reorganized company at a 35% discount to the expected value of the stock. Mudrick argued, "Where, as here, it is a virtual certainty that all who will receive rights are going to exercise them, there is no need for any backstop or payment of accompanying fees—much less the astronomical backstop fees that the Backstop Parties seek to extract from the estate here." Mudrick Objection, *supra* note 2, at 14 (footnote omitted).

95. For an argument that rights offerings, which include similar backstopping fees, should be policed for reasonableness, see Shelby V. Saxon, *Chapter 11 Rights Offerings and Private Placements: How Creditors Can Strike a Windfall*, 94 AM. BANKR. L.J. 357 (2020).

cessive fees would diminish the pressure for lenders to join a favored deal and increase the likelihood of competition from other inside lenders.

Another strategy for addressing the chilling effect of RSAs would be more intrusive, though it too would not require legislative change. Courts could forbid parties from using an RSA to prevent inside lenders from offering alternative financing, thus disentangling DIP financing from the RSA. This would be difficult to do if an RSA fee is directly linked to the DIP financing, as it was in Neiman. But if an RSA signatory wished to offer alternative financing, the court could require that the signatory be permitted to participate in the RSA (and fees linked to the RSA) if its financing offer did not prevail. In contexts where the RSA fee is not linked directly to DIP financing, a court could make clear that it would not enforce an RSA covenant that treats an alternative DIP financing offer as an event of default under the RSA.

I have focused primarily on judicial correctives, in part due to the greater ease of implementation. Courts can intervene immediately, whereas legislation is much more uncertain, especially given that the flaws in the bankruptcy-lending market may not seem sufficiently urgent to capture lawmakers' attention. Attempting to remedy these frictions legislatively is also more likely to have unintended consequences than case-by-case intervention by courts.

Despite the advantages of judicial oversight, the chilling effect of RSAs on competitive lending also could be addressed legislatively. Indeed, the prohibition on provisions that prevent potential lenders from offering bankruptcy financing, as discussed earlier,[96] could easily be made broad enough to invalidate RSAs to the extent that they prevent potential lenders from offering alternative financing.

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Although the fragmented capital structure of many current debtors is grounds for optimism about the trajectory of the DIP financing market, especially if the impediments to competition in this market are addressed, it is important to acknowledge the limitations of the developments I have focused on. The increased competition among inside lenders that the Essay identifies and seeks to encourage will only occur with firms that have multiple lenders. Firms that fit the traditional paradigm of relying on a single bank lender for financing, as most smaller corporations still do, will not have the option of seeking funding from an alternative inside lender. These smaller firms already are much less likely to obtain DIP financing, and much less likely to reorganize, than large corporations.[97] Under ordinary circumstances, these outcomes may

96. *See supra* Section III.A.

97. In a recent analysis, Peter Conti-Brown and I found that "73.49% of companies with over \$200 million in assets and 61.94% of companies with assets of \$100-200 million obtained

not be problematic, since few small firms appear to be viable when they file for bankruptcy. But in the event of a crisis that causes even viable firms to default, additional intervention may be needed to assure that these viable firms have access to the funding they need in bankruptcy.[98]

CONCLUSION

From a bankruptcy perspective, the pandemic had an unexpected silver lining: it revealed that a potential solution to the DIP financing market's serious deficiencies is right in front of us. Rather than looking for ways to entice outside lenders to provide more competition for DIP financing, inside lenders may more effectively serve this role. After all, they suffer far less from the information asymmetry that discourages outside lenders from competing with a favored inside lender.

Although competing bidders are already emerging, as in the Neiman Marcus case, they face significant obstacles, including courts' reluctance to grant them nonconsensual priming liens and contractual provisions that forbid potential lenders from offering an alternative source of financing. In addition to identifying these concerns, this Essay has considered how courts and Congress could remove them. Bankruptcy courts need to be more open to priming liens—and as more competing bids emerge, there is some hope they will be—and they should invalidate RSA provisions that interfere with potential alternative-financing offers. Bankruptcy law should be amended to bar loan prohibitions. Increasing competition in the bankruptcy-financing market would reduce the cost of credit for bankruptcy debtors, and it would remove one of the most glaring current impediments to an efficient reorganization process.

S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Carey Law School. *I am grateful to Matthew Bruckner, Robert Rasmussen, David Smith, Wei Wang, and the editors of the* Yale Law Journal *for helpful comments and conversation, and to Caroline Nowlin and Jinle Ye for excellent research assistance.*

bankruptcy financing, whereas only 27.58% of companies with assets of $10-50 million and 4.06% with less than $10 million of assets did." Peter Conti-Brown & David Skeel, Credit Markets and the (Fed's) Visible Hand 24-25 (July 2021) (unpublished manuscript) (on file with author).

98. For an argument that the Federal Reserve's discount window could be used to facilitate bankruptcy financing for small and medium-sized businesses, see *id.*