Roll-ups, Debtor-in-Possession Financing, and Creditor Control in Bankruptcy Reorganization

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Abstract

Using a hand-collected dataset reflecting contractual detail in debtor-in-possession (DIP) lending arrangements in bankruptcy, we document important variation across DIP loans. We focus on a particular interesting innovation in the legal technology of DIP financing—the roll-up. The debtor’s major pre-bankruptcy secured lender commonly steps up to provide DIP financing when a firm goes into Chapter 11. As part of the deal, this inside lender will often demand that all or part of its pre-bankruptcy secured claim be rolled up into the DIP loan—i.e., paid off with a draw on the DIP financing. This refinancing effectively transforms the lender’s pre-bankruptcy claim, whose validity, amount, and collateral position might otherwise be subject to challenge by the debtor or competing creditors, into a fully secured highly prioritized post-bankruptcy claim. The practice is controversial because it is not clearly authorized under the Bankruptcy Code. Because of this potential legal infirmity and the potentially drastic improvement in the secured lender’s position from obtaining a roll-up, we use the presence and size of roll-ups as a proxy for the degree of secured creditor control in bankruptcy. We hypothesize that this level of control potentially portends bad news for unsecured creditors and the prospects for a successful reorganization. We show that larger roll-ups are associated with shorter case duration and higher likelihood of a sale of substantially all the debtor’s assets under § 363 of the Bankruptcy Code. Additionally, using instrumental variable estimation, we show that roll-up size reduces the likelihood that the debtor will emerge from bankruptcy and increases the likelihood that the debtor will later refile for bankruptcy. Ours is the first study to test the effects of variation across DIP financing arrangements on case outcomes.

Keywords: bankruptcy, reorganization, Chapter 11, DIP financing, roll-up.

JEL Classification: G10, G21, G33, G34, K22.

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