NYSBA SPRING/SUMMER 2006 | VOL. 24 | NO. 1

Inside

A publication of the Corporate Counsel Section
of the New York State Bar Association

Message from the Chair

As the new Chair of the Corporate Counsel Section, I would like to welcome you to the new edition of *Inside*, and give you some exciting information about the activities of our Section this year. This is the Corporate Counsel Section's 25th year, and we have a series of initiatives that should provide our members with significantly enhanced value for your membership. In addition, a number of CLE accredited programs are being planned to give you pertinent information tailored specifically to the needs of corporate counsel. Finally, we invite you to get involved by joining one of our active committees.

The Corporate Counsel Section is engaged in a multi-year effort to retool the Section to not only be more responsive to its members and the public at large, but to give more focus to its efforts to achieve its goals. To that end, the Section has completed, or is in the process of implementing, the following exciting efforts:

1. **Revision of the Bylaws**. The Section recently revised its bylaws to allow for a more inclusive membership. Membership is no longer limited to those who serve as in-house counsel to a business organization. Now, anyone who practices law who has an interest in the unique role of in-house counsel is welcome to join and become active in the Section.

2. **Detailed Membership Survey**. The Section completed a membership survey to be more effective in developing programs that serve the needs of the Section's members. I am pleased to announce that, because the Section now has over 1,600 active members, we now have two delegates to the Association's governing House of Delegates. Moreover, our first delegate, Conal Murray, has successfully organized a Section Delegates Caucus to ensure that the voices of the Sections are heard in the House of Delegates. We look forward to the efforts of both Conal and our second delegate, Thomas Reed, in making sure your needs are addressed in the House.

3. **First Corporate Counsel Institute**. In September 2005, the Section sponsored its first Corporate Counsel Institute, a comprehensive two-day program focusing on the areas of law of particular interest to in-house counsel, including ADR for Employment Law, In-house Compliance Issues, Litigation and E-discovery, Law Department Management, Intellectual Property and Ethics for Corporate Counsel. Our next Corporate Counsel Institute is planned for the Fall of 2007, chaired by Gary Roth, Vice-Chair of the Section.

Inside

Corporate Legal Diversity Pipeline Program 3
(Megan Hanson)

Whistleblower Claims Under Sarbanes-Oxley: Which Employers Are Covered? 5
(Ira Rosenstein and Renee Phillips)

Debtor-in-Possession Financing 8
(Marshall S. Huebner)

NYSBA

4. **Ethics for Corporate Counsel**. The Section once again presented its successful annual program, Ethics for Corporate Counsel, to address ethical issues particular to in-house counsel. This year the ethics program was contained within the Corporate Counsel Institute. The next Ethics for Corporate Counsel program is planned for early October of 2006, chaired once again by Steve Nachimson, Chair-Elect of the Section and Chair of the CLE committee.

5. **Diversity Internship Program**. The Section has established a diversity internship program, named for former NYSBA President Kenneth G. Standard, to place interns from diverse groups in in-house summer positions. The diversity internships will commence Summer 2006. The Section's Internship Committee, headed by past Section Chair Barbara Levi, plans to recruit interns from a diverse group of law school candidates. Three internships are expected to be awarded to students who have successfully completed one or two years of law school at an accredited New York State school.

6. **Reappointment of Committees**. The Section has implemented six working committees, each charged with activity in areas of expressed interest by members. Those committees include Membership, Internship, Corporate Governance, Pro Bono, *Inside* and Continuing Legal Education.

7. **Pro Bono Program**. The Section's Pro Bono Committee works with the NYSBA Pro Bono Department and the Pro Bono Partnership to develop ways in which in-house counsel can perform pro bono service. In addition to a special issue of *Inside*, the committee provides regular liaison between members and pro bono organizations, and co-sponsored a program on law firm and in-house pro bono on April 27, 2006 in Rochester.

8. **Continuing Legal Education and Publications**. In addition to the Ethics for Corporate Counsel Program, and the First Corporate Counsel Institute, the Section is a frequent co-sponsor of other continuing legal education programs with other NYSBA Sections, in areas of interest to in-house counsel, such as business law, international law, and commercial litigation.

   The Section is co-sponsoring a Summer Meeting with the General Practice Section on July 14-16, 2006, at the Hotel Thayer on the grounds of the United States Military Academy at West Point. This exciting program will feature a leadership seminar by the Commandant of the USMA, as well as programs of interest to inside counsel. You will receive additional information about this program as the summer approaches. The Section is also planning several other CLE programs this year to address a variety of interesting topics.

9. **Strategic Planning Process**. The Section is undergoing a strategic planning process to examine the goals of the Section, and strategies for achieving those goals.

There are several ways for you to get involved with these efforts. First, we encourage interested members to join one of our committees. There are currently vacancies on the following committees:

- *Inside* Editorial Board
- Corporate Governance
- Pro Bono
- Diversity Internship Program
- Continuing Legal Education

Additionally, there are vacancies on the Executive Committee of the Section. If you are interested in being considered for an appointment to any of these committees, please email me at steven.mosenson@nyu.edu.

I hope that you enjoy this issue of *Inside*, and I encourage you to join with me in commemorating the Section's 25th anniversary by actively participating in our efforts to re-energize our Section.

Steven H. Mosenson

Corporate Legal Diversity Pipeline Program

By Megan Hanson

This January, 150 high school students from three Montgomery County, MD, schools spent the day at Marriott International, Inc., negotiating contracts, mediating disputes, and investigating an employee misconduct claim. The students weren't actually working on live Marriott issues, but rather simulating the sorts of activities that Marriott lawyers and legal staff do on a day-to-day basis. The students working on negotiating contracts, for example, were given a fictional fact pattern about a high school that wanted to hold its prom at a Marriott hotel. Some students represented the high school, and others the company, and together, they set about to come to an agreement on the terms of such a contract. The students became absorbed in their negotiations, defending their clients interests and pushing for a favorable settlement.

The students, like many others around the country, were afforded this opportunity through their participation in the Corporate Legal Diversity Pipeline Program, a joint effort of the non-profit Street Law, Inc. and the Association of Corporate Counsel. The program partners corporate legal departments with nearby diverse, high school law classes in an effort to engage the students, teach them more about civil law, and encourage them to consider careers in the legal profession.

Most lawyers would agree that their profession is not nearly representative of the diversity in our country. In fact, the numbers show quite a challenge. Lawyers of color make up less than 15% of the bar, while racial and ethnic minorities make up approximately 30% of the United States population. While achieving exact racial proportions is not the goal of the legal profession, most recognize that a diverse workforce benefits clients, the profession, and the general population. Many in the legal profession have implemented diversity programs and strategies to address the problem—programs that often deal with the existing workforce. These important efforts will be stalled, however, if we are not first providing the workforce with a new influx of diverse talent. The heart of the problem is that too few students of color are entering the profession.

The Corporate Legal Diversity Pipeline Program tackles this problem by focusing on strategies that will encourage and better prepare students of color to enter the legal profession. By providing the students with role models and the opportunities to connect with lawyers, and by providing them the opportunity to experience the types of work lawyers do, the students are able to broaden their impressions of the legal profession and fuel their interest in legal careers. The program sets out to achieve these objectives through three program components: classroom visits, a conference at the corporate headquarters, and program extensions for the most promising students.

> *"Most lawyers would agree that their profession is not nearly representative of the diversity in our country."*

Corporations are paired with nearby diverse schools to facilitate opportunities to bring the lawyers into the classroom. For example, Coca-Cola is paired with three close Atlanta public high schools. The lawyers work with students in the schools' law classes, visiting the classroom to help teach about important civil law topics. The lawyers might cover intellectual property, torts, negotiation, mediation or employment law in the classroom—bringing to life topics that can appear quite boring in textbook form. Towards the end of the semester, the students take a field trip to Coca-Cola's corporate headquarters, where they spend the day engaging in challenging and thought-provoking activities that utilize the knowledge and skills they learned in the classroom. A highlight of the day at the corporate campus is the career fair, where students have the opportunity for one-on-one discussions with lawyers, paralegals, or administrative staff from the legal department. Students often request business cards from their new professional friends and learn about the importance of communication and networking.

After the semester ends, the corporations provide some sort of extension of the experience for the most interested and promising students. Choice Hotels, in suburban Washington, D.C., for example, offers summer internships to two of the students they worked with during the school year. The internships are competitive, and students must apply through the human resources department, where they experience the application, interview and hiring process. Some corporations are investigating scholarship programs, while others work on creating lasting mentoring relationships between the students and corporate volunteers.

The effectiveness of the components of the Diversity Pipeline Program is supported by career choice research. The research suggests that there are several important influences on a young person's career choice, including belief in their ability to be successful at that career, social persuasion to pursue that career, and role-modeling of the career by people they admire. The Diversity Pipeline program affords students opportunities to learn about what it takes to be a lawyer and to put those "lawyering" skills to use in interactive simulations; and the more chances they have to use their skills and be successful, the more likely they are to believe that they can succeed in a legal career. Connections with powerful, positive role models are especially important for students who may not know any lawyers or legal professionals, and for students that have thus far only had negative experiences with the law. Learning about the wealth of opportunities in civil law opens the eyes of students who had previously thought that all lawyers spend their time arguing in a courtroom, "Law and Order"-style.

The program, which has been running for four years and is now being implemented by more than a dozen corporations in eight cities, is beginning to show anecdotal evidence of success. Several volunteers have kept in touch with students who are in college, intent on studying the law. Of course, the real measure of success will come several years down the road, when the students we're working with today are entering the professional world.

While the idea of entering a classroom full of high school students to teach them about the law seems overwhelming to newcomers, corporate volunteers quickly find the program to be immensely rewarding, and often, easier than they expected. Since they are only being asked to help teach about their practice areas, they don't have to research a field with which they're unfamiliar. Street Law, Inc. provides training, support and technical assistance to participating corporations, as well as an electronic library of field-tested lessons and workshops used by other corporations. Once the corporation has been through a semester, preparation time significantly decreases as they retool previous lesson plans.

The volunteer attorneys, paralegals and administrative assistants also enjoy designing the simulations in which students will participate at the conference. Each corporation approaches a topic in a way that directly connects to their business and the legal department's activities. The students appreciate the authenticity of the simulations, and the opportunity to play the role of a lawyer who works for Marriott, Coca-Cola, General Motors, or McDonald's. Teachers frequently comment that they see a level of student engagement at the corporate conference that far exceeds what they typically observe in the classroom.

At General Motors' Detroit conference in 2004, students simulated a state environmental agency board hearing to decide whether the company's proposed new auto plant would comply with air and water regulations. Students played the roles of agency members, GM attorneys, concerned citizens and experts. In Atlanta at Coca-Cola's 2005 conference, students mediated a mock dispute between the company and a fictional athlete contracted to promote a company beverage. The athlete had broken the morals clause in his contract and the parties gathered to restructure the deal. Experiences such as these are valuable for the students and the corporate volunteers. Barbara Sardella, a lawyer participating in the program through the Central Pennsylvania Chapter of the ACC, said of the program, "it's one of the most rewarding things I've ever done in my law career."

Corporations find the program intriguing because it represents a melding of traditional *pro bono* activities with community outreach and diversity efforts. The program can involve all members of the department, while traditional *pro bono* activities usually offer only involvement for attorneys. As an exciting partnership, the program often draws the attention of the media and positive stories are published in local newspapers. And, due to the support and assistance of Street Law, a non-profit dedicated to law and democracy education, corporations don't have to design a program from scratch or "reinvent the wheel." Street Law has more than 30 years of expertise in law-related education, and authors the nation's leading high school law text—*Street Law: A Course in Practical Law.*

Jim Akers, associate general counsel at Marriott International, Inc., summed up his firm's feelings about the program when he told the *Washington Post*, "I think we are helping more people think about the profession and, more specifically, we're encouraging a more diverse group to enter the law. This is a great way for Marriott to serve the community."

Megan Hanson is the Program Coordinator for Street Law, Inc. More information about the Corporate Legal Diversity Pipeline Program is available at http://www.streetlaw.org/pipeline.asp, or by contacting Street Law's Director of U.S. Programs, Lee Arbetman (larbetman@streetlaw.org, 301.589.1130 x 230).

Whistleblower Claims Under Sarbanes-Oxley: Which Employers Are Covered?

By Ira Rosenstein and Renee Phillips

Sarbanes-Oxley ("SOX" or the "Act"), 18 U.S.C. § 1514A (2002), establishes protections for employees of public companies who are retaliated against for reporting conduct that they "reasonably believe" constitutes a violation of certain enumerated federal anti-fraud laws. SOX has created a cottage industry of new claimants, experts and consultants, and has opened the door to a new and potentially costly breed of employment discrimination claims. Not surprisingly, employers have great interest in determining whether they are covered by SOX and the issue has received significant attention from courts and Administrative Law Judges tasked with often murky provisions of the legislation.

A. Publicly Traded Companies, Officers, Employees, Contractors, Subcontractors or Agents

SOX focuses on public companies registered under section 12 (or those required to file reports under section 15(d) of the Securities and Exchange Act of 1934; officers, employees or agents of such public companies; and contractors and subcontractors of such public companies. *See* 18 U.S.C. § 1514A(a); *see also* 29 C.F.R. § 1980.101 (defining "company," "company representative" and "employee"). The emerging case law suggests that this definition is far broader in scope than those of many similar whistleblower and anti-retaliation statutes.

For example, federal anti-discrimination laws generally permit claims to be brought against "employers," but not individual managers or other employees. The legislative history of SOX, in contrast, is replete with references to the fact that the Act was also intended to address the actions of individual "employees." *See* 148 Cong. Rec. S6439-40, 107th Cong., 2d Session (2002). Moreover, the Department of Labor regulations refer to Sarbanes-Oxley's "unique" statutory provisions that "identify individuals as well as the employer as potentially liable for discriminatory action." 29 C.F.R. § 1980.101. As a result, SOX charges filed to date that name individual respondents in addition to the employer have been processed, treating the individuals as proper parties. *See, e.g., Gallagher v. Granada Entmt. USA, ITV plc*, 2004-SOX-74 (ALJ Oct. 19, 2004).

In addition, under certain circumstances, non-publicly traded subcontractors or agents of publicly traded companies may be held liable under SOX. In *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005), the complainant was an employee of a public company, DVI, which was going through bankruptcy and dissolution. DVI contracted with a non-publicly traded company, AP Services, to provide restructuring services during the bankruptcy, which included providing DVI with a President and CEO.

> *"SOX has created a cottage industry of new claimants, experts and consultants, and has opened the door to a new and potentially costly breed of employment discrimination claims."*

The President and CEO provided by AP terminated the complainant's employment with DVI, and she filed a SOX complaint against both DVI and AP. The ALJ found that AP was a subcontractor and an agent of DVI and/or DVI's trustee in bankruptcy, and could therefore be held liable under SOX.

Similarly, in *Minkina v. Affiliated Physician's Group*, 2005-SOX-19 (ALJ Feb. 22, 2005), the ALJ noted that the respondent, who was a subcontractor for covered companies, could theoretically engage in prohibited retaliation against employees of those covered companies, even though it was not a publicly traded company itself. In that case, no liability could be found because the complainant was an employee of the subcontractor, not of the publicly traded company.

There are limits to the scope of SOX coverage, however. For example, in *Flake v. New World Pasta Co.*, 2003-SOX-18, 03-ARB-126 (Feb. 25, 2004), the Administrative Review Board held that, pursuant to the plain language of the Act, even when an employer is a publicly traded company, it is not covered if it is not registered under section 12 or required to file reports under section 15(d). In *Gallagher v. Granada Entertainment USA, ITC plc*, 2004-SOX-74 (ALJ Apr. 1, 2005), the ALJ held that a company could only be potentially liable under SOX for those alleged adverse actions that occurred after it merged with another company and thereby became a covered entity. In *Roulett v. American Capital Access*, 2004-SOX-78 (ALJ Dec. 22, 2004), the ALJ held that the respondent was not a covered employer where it had filed a registration statement pursuant to section 12 but then requested withdrawal of the statement before any approval by an exchange or the SEC was effected. The ALJ further rejected the complainant's argument that the respondent was a "company representative" for publicly traded companies because those companies rely on its services and purchase its products. Similarly, in *Brady v. Calyon Securities (USA)*, No. 05 Civ. 3470, 2005 WL 3005808, at *8 (S.D.N.Y. Nov. 8, 2005), a federal district court rejected the plaintiff's claim that he was covered by SOX because his employer, although not publicly traded, had acted as an agent or underwriter of numerous public companies. In so holding, the court stated that the "agency" provision of SOX applies only to companies that have acted as agents of publicly traded companies "with respect to their employment relationships." *See also Stevenson v. Neighborhood House Charter Sch.*, 2005-SOX-87 (ALJ Sept. 7, 2005) (rejecting complainant's argument that a non-publicly traded employer was covered by SOX because it has a retirement plan subject to the reporting and disclosure requirements of ERISA, and/or because it was subject to sections 302, 401, 404 and 406 of SOX and certain provisions of the Securities Exchange Act); *Judith v. Magnolia Plumbing Co., Inc.*, 2005-SOX-99, 100 (ALJ Sept. 20, 2005) (rejecting complainant's argument that non-publicly traded employer was covered by SOX because it was a contractor for municipal and federal governments).

Despite these decisions limiting the scope of SOX coverage, the implications of *Kalkunte* and *Minkina* should not be underestimated. Publicly traded companies often hire consultants to help them improve efficiency and decrease costs. Such consulting companies, to the extent they are not publicly traded, may not realize that they could be covered by section 806, particularly if they have not had to comply with all of the other requirements of the Act. It is unclear how broadly the coverage of subcontractors and agents will ultimately extend. For example, will a complainant have to demonstrate that a subcontractor or agent is a "joint employer" in order to state a claim, which was essentially the situation in *Kalkunte*? Or will any direct or indirect feedback that affects an employee's terms or conditions of employment be sufficient to confer potential liability? The more restrictive "joint employer" or "integrated enterprise" approach has been the typical analysis used by courts to determine potential liability under federal antidiscrimination laws such as Title VII; however, those laws do not specifically include subcontractors and agents as potentially covered. Thus, it is likely that ALJs and courts will reject this approach in construing the coverage of section 806, leading to a higher volume of whistleblower claims with the potential to be brought under SOX.

B. Non-Publicly Traded Subsidiaries

Although there are a number of somewhat contradictory Administrative Law Judge decisions on this point, the emerging case law suggests that non-publicly traded subsidiaries of publicly traded companies may face liability under SOX.

In *Morefield v. Exelon Services, Inc.*, 2004-SOX-2 (ALJ Jan. 28, 2004), an ALJ ruled that a non-publicly traded subsidiary of another non-publicly traded subsidiary of a publicly traded company was a covered employer and its employees could state a claim for retaliation under SOX. The ALJ very broadly defined the term "employee of a publicly traded company" to include "all employees of every constituent part of the publicly traded company, including but not limited to, subsidiaries and subsidiaries of subsidiaries which are subject to internal controls, the oversight of its audit committee, or contribute information, directly or indirectly, to its financial reports."

Similarly, a publicly traded holding company of a non-publicly traded employer has been deemed an employer under certain circumstances. In *Platone v. Atlantic Coast Airlines*, 2003-SOX-27 (ALJ Apr. 30, 2004), the publicly traded holding company of a non-publicly traded subsidiary for which the complainant worked was held to be an employer for the purposes of SOX. The ALJ in that case essentially pierced the corporate veil and concluded that the holding company held itself out as the entity ultimately responsible for the subsidiary's actions. *Cf. Gonzalez v. Colonial Bank*, 2004-SOX-39 (ALJ Aug. 20, 2004) (holding that complainant was a covered employee where he alleged that the publicly traded parent of a non-publicly traded subsidiary for which he worked was jointly responsible for his termination); *McIntyre v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 2003-SOX-23 (ALJ Sept. 4, 2003) (allowing complainant to add parent as a respondent where there were issues of fact as to whether wholly-owned subsidiary and parent were "joint employer").

Despite these decisions, there is still support for the argument that a publicly traded company is not an employer of all of its subsidiaries' employees. In *Mann v. United Space Alliance*, 2004-SOX-15 (ALJ Feb. 18, 2005), the complainant sued his employer, United Space Alliance ("USA"), a non-publicly traded company, as well as Boeing and Lockheed Martin, both publicly traded companies, which equally owned USA and operated it as a joint venture. In determining whether any of the respondents were covered by the Act, the ALJ first examined whether Boeing or Lockheed Martin could be covered by virtue of being companies "which could affect" the complainant's employment. The ALJ found that Boeing and Lockheed Martin played no role in the management of employees of USA other than its President and CEO, that the companies were not aware of Mann's reporting activities, and that the companies took no action with respect to Mann's employment. The ALJ then analyzed whether USA acted in conjunction with its parent companies such that either the private subsidiary or the public companies could face liability. The ALJ noted that USA was responsible for its own day-to-day management, and there was no evidence that USA employees were subject to internal control by either Boeing or Lockheed Martin or that USA was an inseparable, integral part of either of the companies. Concluding that USA operated as a separate and distinct entity from either of its owners, the ALJ held that none of the respondents were covered by the Act with respect to Mann's claims. *See also Powers v. Pinnacle Airlines, Inc.*, 2003-AIR-12 (ALJ Mar. 5, 2003) (holding that non-public subsidiary of publicly traded airline was not subject to SOX).

C. Conclusion

As the above cases illustrate, the question of who is a covered employer has been hotly contested under the whistleblower provisions of SOX. As is true for any newly enacted statute with elaborate administrative enforcement procedures, it will take years for the courts to issue definitive guidance on the parameters of the SOX whistleblower provisions. In the meantime, non-public subsidiaries and subcontractors of publicly traded companies must not assume that they are immune from the dictates of the whistleblower provisions. Unless and until the courts declare otherwise, many such companies are likely to find themselves subject to these provisions to the same extent as publicly traded entities.

Ira Rosenstein is an Employment Law Partner in the New York office of Orrick Herrington & Sutcliffe LLP, representing employers in all aspects of employment litigation, arbitration and counseling. Renee Phillips is an associate at Orrick in its employment department. Orrick Herrington & Sutcliffe LLP's telephone number is (212) 506-5000 and their website address is http://www.orrick.com.

Debtor-in-Possession Financing

By Marshall S. Huebner

It may seem counterintuitive that banks and other institutions would compete fiercely to provide loans to companies that have recently filed for protection under Chapter 11 of the U.S. Bankruptcy Code. But they do—and often. Indeed, "DIP loans," as they are called, are big business and can range from tens of thousands to billions of dollars. Moreover, lending institutions of all sizes may be called on to extend further credit to a bankruptcy debtor to "protect" an existing loan position.

"It may seem counterintuitive that banks and other institutions would compete fiercely to provide loans to companies that have recently filed for protection under Chapter 11 of the U.S. Bankruptcy Code. But they do—and often."

Companies that enter into Chapter 11 reorganization continue to be run by their existing management in virtually all cases. The ongoing entity is known as the debtor in possession, or DIP. In Chapter 11, pre-bankruptcy creditors are, for the most part, stayed from enforcement remedies and do not receive payment of principal or interest while the company seeks to rationalize its business and formulate a plan of reorganization to restructure its balance sheet.

The DIP typically finds itself in need of credit immediately after initiating Chapter 11. While most of its pre-bankruptcy liabilities are frozen, the company is likely to need cash immediately to cover payroll and the up-front costs of stabilizing the business. Although post-bankruptcy credit extended by vendors is granted administrative expense priority over all pre-bankruptcy unsecured claims, vendors typically place Chapter 11 debtors on C.O.D. or C.B.D. until the company stabilizes and working capital financing for the company's ongoing operations is available.

DIP loans are typically asset-based, revolving working-capital facilities put into place at the outset of Chapter 11 to provide immediate cash as well as ongoing working capital during the reorganization process. Perhaps most important, DIP financing helps the company restore vendor confidence in the company's ability to maintain its liquidity.

Protections for DIP Lenders

Congress understood that lenders might well be skittish about extending additional credit to a company that has filed for bankruptcy, so the Bankruptcy Court extends to DIP lenders a number of powerful protections. If the debtor can demonstrate that financing could not be procured on any other basis, the Court can, subject to certain limitations, authorize the debtor to grant the DIP lender a lien that has priority over pre-bankruptcy secured creditors (priming lien) and a claim with superpriority over administrative expenses (including vendor and employee claims) incurred during Chapter 11 and over all other claims.

The DIP lender typically will insist on a first priority priming lien on the debtor's inventory, receivables, and cash (whether or not previously encumbered), a second lien on any other encumbered property, and a first priority lien on all of the debtor's unencumbered property.

A priming lien can be granted only with the consent of the secured creditors (who are primed) or if the court finds that the creditors are adequately protected despite the granting of the priming DIP lien. In many cases, pre-bankruptcy inventory and receivables lenders consent to being primed and to the use of their cash collateral in exchange for a package of protections specified in the court order approving the financing (DIP Order). These protections typically include a second lien on unencumbered assets (behind the DIP loan) and, quite often, current cash payment of interest. One reason secured lenders often consent to being primed is because the value of their collateral interest (and thus their recovery) will plummet unless new money is lent to the debtor to maintain operations and inspire vendor and customer confidence.

In common bankruptcy parlance, a DIP loan provided by the existing secured lenders is referred to as a "defensive "DIP while a loan from a new third-party lender is called an "offensive" or "new money" DIP.

Creditors secured by isolated assets often do not consent to being primed, and, assuming the DIP lender is satisfied with its other collateral, the DIP lender often does not seek to prime existing lenders with respect to these assets.

In addition to collateral and a superpriority claim, DIP loans are typically designed with covenants and other protections to permit the DIP lender a full recovery even if the debtor liquidates. The loan documents and/or the DIP Order, for example, will typically include a provision concerning the borrowing base that 1) all asset sale proceeds must be applied to reduce the DIP commitments; 2) the primed pre-bankruptcy lenders cannot exercise remedies until the DIP has been repaid; and 3) certain events, like conversion of the case to Chapter 7 or appointment of a trustee in bankruptcy, permit the DIP lender to call the loan.

DIP Loan Negotiation and Pricing

In larger cases, DIP loans typically are negotiated over a one- or two-week period just prior to the commencement of Chapter 11 proceedings. The lender arranging the DIP loan typically first enters into an engagement letter providing for an advance against expenses and then sends internal or external experts to conduct an expedited review of the working capital collateral and the debtor's post-Chapter 11 cash flow projections. Once the lender satisfies itself regarding the collateral and the DIP financing has been "sized" based on the debtor's expected needs, the parties proceed to a commitment letter and final documentation. In some cases, where there is time pressure, the commitment letter stage is bypassed.

DIP loans are often sized to be somewhat—or far—larger than the expected needs of the debtor because announcing a large facility may inspire vendor confidence and actually reduce the need for use of the facility. Sometimes the DIP lender, through various mechanisms, will limit use of the oversized part of the facility so the lender is comfortable it will be protected if the debtor exceeds its forecasted usage. Besides offering the marketplace a sense of comfort, oversizing the debt benefits the DIP lender because commitment and facility fees apply to the full facility, whether or not the debtor uses it all.

Pricing on DIP loans has historically been relatively high for first-lien working-capital financing, but the DIP lending business has become more competitive during the past 10 years and pressure on pricing has increased. Lately, hedge funds and other new entrants in the DIP lending market have further increased competition. Pricing will often include a fee paid at the time of the initial commitment letter, further fees paid at the time the loan is closed, ongoing commitment fees, and, of course, interest on the loans themselves. The pricing can be affected by a number of factors, such as whether the facility is a defensive DIP (where pricing will tend to be somewhat lower) and whether the DIP lender is the only available source of funds (where pricing will likely be somewhat higher).

Syndication of larger DIP facilities often waits until after Chapter 11 proceedings begin. Sometimes the lead arranger underwrites the entire facility; other times a small group of initial participants is included. The early entrants are, of course, able to obtain a larger share of the up-front fees, inducing lenders to become part of the underwriting group.

DIP Loan Approval Process

Approval of priming liens and superpriority claims in connection with a DIP loan requires "notice and hearing" under the Bankruptcy Code, and it is the debtor's burden to demonstrate that lenders who are being primed are being "adequately protected." However, because the debtor typically needs to draw on the facility at the outset of the Chapter 11 proceeding and because it is desirable to obtain early approval of the DIP financing to restore vendor confidence, DIP loans are typically approved in a two-step process during the first month of the Chapter 11 case.

1. In the first step, an interim DIP hearing is held within a couple of days after the Chapter 11 petition is filed, on notice to a) the lenders who are being primed, b) the 20-50 largest unsecured creditors of the debtor (depending on the size of the case), and c) the office of the U.S. Trustee (a division of the U.S. Department of Justice that is designated in the Bankruptcy Code to perform a number of functions in bankruptcy cases). At the interim DIP hearing, the debtor seeks approval to use only that portion of the DIP commitments it will need until a final DIP hearing can be held.
2. The final DIP hearing will generally be scheduled within 20 to 30 days after the official committee representing the interests of unsecured creditors (the Creditors' Committee) is appointed.

If objections are made at the interim DIP hearing, they usually come from the U.S. Trustee. While the timing and amount of fees paid to the DIP lender are sometimes an issue, more typically the U.S. Trustee raises issues relating to the adequate protection package being offered to the pre-bankruptcy lenders being primed by the DIP. Occasionally, there will be a dispute over whether the terms of the proposed DIP are the best available. Assuming the judge is satisfied, an interim DIP Order is entered, and the loan documents are signed promptly to make a portion of the DIP facility available to the debtor. The interim DIP Order will specify the date of the final DIP hearing.

The balance of the commitments under the DIP facility will be approved at the final DIP hearing, after the Creditors' Committee has had time to review the deal. Syndication of the DIP loan, if the arranger decides to do so, typically is completed by the time of the final hearing.

On occasion, the Creditors' Committee will object to some terms of the deal or the adequate protection package, and the Committee's objections will have to be resolved by negotiation or overruled by the Court. In many cases, the Creditors' Committee recognizes the need for the DIP facility and any objections it has are resolved before the final hearing. At the hearing, the Court will then enter the final DIP order.

If a DIP Order Is Overturned on Appeal

Orders approving DIP financings are rarely appealed. However, given the litigation overlay of a bankruptcy proceeding, a prospective DIP lender may legitimately ask what happens in the unlikely event an appeal is taken and the DIP Order is reversed. Anticipating concerns among lenders on this score, Congress included a provision in the Bankruptcy Code stating that reversal or modification of the DIP Order (including the granting of priority and liens) "does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended credit in good faith" unless the effect of the DIP Order was stayed pending appeal. Most DIP orders therefore contain an express good-faith finding.

Perfecting a DIP Lender's Lien

Because the Bankruptcy Court has jurisdiction over the debtor's property, DIP Orders usually contain a provision stating that the DIP liens are perfected without further action under state law. However, while the order is occasionally relied on without further lien filings, in most cases DIP lenders take the further steps of signing normal collateral documentation and completing necessary filings. Often this is accomplished in due course after closing, and the DIP Order typically contains "further assurances" language requiring the debtor to complete this documentation. One of the reasons DIP lenders typically decline to rely solely on the DIP Order is the possible need to enforce their liens in a forum other than the Bankruptcy Court. If this becomes necessary, it is helpful to have already completed the necessary state law filings.

Conclusion

Lending to a company in Chapter 11 is of course complex from a variety of perspectives, and this article does not address the numerous technical aspects of debtor-in-possession financing. As with any other extension of credit, each DIP lending opportunity should be carefully evaluated from a business and legal perspective. Particular attention should be focused on the quality of the liquid collateral, the credibility of the debtor's projections, the rights of third-party creditors, and the attitudes of the U.S. Trustee's office and the court where the bankruptcy case is pending. That said, in many cases, it can be an eminently logical and profitable endeavor. Indeed, because of the many lender protections enshrined in the U.S. Bankruptcy Code to induce DIP lending, the safest loans in a troubled industry may well be those made to bankruptcy debtors.

Marshall Huebner is a partner at Davis Polk & Wardwell in New York. His recent representations include serving as lead counsel to Delta Air Lines, and to the DIP lenders in Enron and Adelphia Communications, as well as to the pre-petition lenders in Polaroid, Loral, Citation and Crown Paper.

Corporate Counsel Section Executive Committee Members

Mitchell F. Borger
Federated Dept. Stores, Inc.
151 West 34th Street, 13th Floor
New York, NY 10001

Lawrence D. Chesler
1327 North Dearborn Parkway
Unit 3
Chicago, IL 60610

Bonni G. Davis
Finlay Fine Jewelry Corporation
529 Fifth Avenue, 6th Floor
New York, NY 10017

Albert W. Driver, Jr.
The Metropolitan Corporate Counsel
1180 Wychwood Rd.
Mountainside, NJ 07092

Alan J. Flink
Federated Dept. Stores Inc.
Law Office, 13th Floor
151 West 34th St.
New York, NY 10001

Jeffrey L. Futter
Con Edison
4 Irving Place, 1625-S
New York, NY 10003

Janice Handler
The Association of the Bar
of the City of NY
42 West 44th Street
New York, NY 10036

Barbara M. Levi
Unilever U.S. Inc.
700 Sylvan Avenue
Englewood Cliffs, NJ 07632

Jay L. Monitz
Federated Dept. Stores Inc.
Law Office, 13th Floor
151 West 34th Street
New York, NY 10001

Conal E. Murray
196 Croton Avenue
Mount Kisco, NY 10549

David B. Perlman
Citizen Watch Co. of America
15 Country Club Lane
Scarborough, NY 10510

Michael J. Pisani
167 Rockaway Avenue
Garden City, NY 11530

Michael J. Pollack
11 Morewood Oaks
Port Washington, NY 11050

Thomas A. Reed
1172 Park Avenue, Suite 15-c
New York, NY 10128

David S. Rothenberg
Goldman Sachs/The Ayco Company
1 New York Plaza, 40th Floor
New York, NY 10004

Howard S. Shafer
87 Spring Lane
Englewood, NJ 07631

Rachelle Stern
Federated Dept. Stores Inc.
151 West 34th St.
New York, NY 10001

Allison B. Tomlinson
DY Consultants
1 Expressway Plaza, Suite 208
Roslyn Heights, NY 11577

Corporate Counsel Section Committee Chairs

CLE & Meetings

Steven Nachimson
Compass Group USA, Inc.
3 International Drive, 2nd Floor
Rye Brook, NY 10573

Inside/Publications

Bonni G. Davis
Finlay Fine Jewelry Corporation
529 Fifth Avenue, 6th Floor
New York, NY 10017

Internship

Barbara M. Levi
Unilever U.S. Inc.
700 Sylvan Avenue
Englewood Cliffs, NJ 07632

Membership

Thomas A. Reed
1172 Park Avenue, Suite 15-c
New York, NY 10128

Pro Bono

Steven H. Mosenson
United Cerebral Palsy Associations
of NY
330 West 34th St., 15th Floor
New York, NY 10001

Submission of Articles

Inside welcomes the submission of articles of timely interest to members of the Section. Articles should be submitted on a 3½" floppy disk, preferably in WordPerfect or Microsoft Word, along with a printed original and biographical information. Please submit articles to:

Bonni G. Davis
Finlay Fine Jewelry Corporation
529 Fifth Avenue
6th Floor
New York, NY 10017

Visit Us on Our Web Site:

www.nysba.org/corporate

Inside

Editor
Bonni G. Davis, Esq.
Finlay Fine Jewelry Corporation
529 Fifth Avenue, 6th Floor
New York, NY 10017

Section Officers

Chair
Steven H. Mosenson
United Cerebral Palsy Associations of NY
330 West 34th St., 15th Floor
New York, NY 10001

Chair-Elect
Steven Nachimson
Compass Group USA, Inc.
3 International Drive, 2nd Floor
Rye Brook, NY 10573

Vice-Chair
Gary F. Roth
Broadcast Music, Inc.
320 West 57th Street
New York, NY 10019

Secretary
Fawn M. Horvath
Federated Dept. Stores Inc.
Legal Department, 13th Floor
151 West 34th Street
New York, NY 10001

Treasurer
Michael E. Kreitman
Federated Dept. Stores Inc.
151 West 34th Street
New York, NY 10001

Inside is a publication of the Corporate Counsel Section of the New York State Bar Association. Members of the Section receive a subscription to the publication without charge. Each article in this publication represents the author's viewpoint and not that of the Editors, Section Officers or Section. The accuracy of the sources used and the cases, statutes, rules, legislation and other references cited is the responsibility of the respective authors.

ISSN 0736-0150

NYSBA

Corporate Counsel Section
New York State Bar Association
One Elk Street
Albany, NY 12207-1002

ADDRESS SERVICE REQUESTED

NON PROFIT ORG.
U.S. POSTAGE
PAID
ALBANY, N.Y.
PERMIT NO. 155