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DUE DILIGENCE IN BANKRUPTCY: DIP FINANCING AND SECTION 363 SALES

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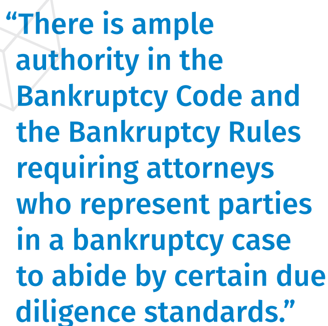

"There is ample authority in the Bankruptcy Code and the Bankruptcy Rules requiring attorneys who represent parties in a bankruptcy case to abide by certain due diligence standards."

Legal practitioners are often tasked with conducting due diligence. Depending on the deal or transaction, the due diligence process can present itself in different ways.

It may be a fact-finding expedition that requires asking clients questions and confirming assertions. For instance, you may need to find out how the company's legal name is listed on state records, whether the client has perfected a lien, or if there are outstanding liens against a debtor.

If you're a transactional lawyer, you may be familiar with due diligence in the context of mergers and acquisitions, lending, real estate, and other similar transactions.

But due diligence also plays an important part in bankruptcy. Courts have consistently held that counsel for the debtor must conduct proper due diligence of the debtor's assets. Attorneys representing creditors in bankruptcy likewise have to conduct proper due diligence, especially when participating in Chapter 11 debtor-in-possession financing (DIP).

This article explores the due diligence duties that attorneys must consider in the context of bankruptcy.

AUTHORITY FOR DUE DILIGENCE

There is ample authority in the Bankruptcy Code and the Bankruptcy Rules requiring attorneys who represent parties in a bankruptcy case to abide by certain due diligence standards.

Section 536(a)(2) of the Bankruptcy Code provides that counsel for the debtor must conduct due diligence adhering to the "reasonable inquiry" standard, whereby counsel "shall not... make any statement...that is untrue or misleading, or that upon the exercise of reasonable care, should have been known by [counsel] to be untrue or misleading".

Furthermore, Bankruptcy Rule 9011 states that an attorney submitting papers to the court must certify that the information presented is "to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances . . . [and that] the allegations and other factual contentions have evidentiary support . . ."

In other words, such papers must be reliant on reasonable due diligence. This applies to all attorneys filing papers in a bankruptcy court. Similarly, Section 707(b)(4)(c) requires that documents signed by attorneys are reliant on reasonable investigation or due diligence.

Due diligence likewise extends to bankruptcy trustees. In 2019, Congress passed the Small Business Reorganization Act which included significant changes to small business

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bankruptcies. The Act aimed to streamline the bankruptcy process and give small businesses a better chance at surviving bankruptcy. Among other relief, the Act includes a "reasonable due diligence" requirement by the trustee or a debtor in possession upon asserting a preference claim. This new measure was intended to improve the quality of and reduce the number of preference lawsuits.

All of the referenced measures reinforce the need for proper due diligence by attorneys.

JUDICIAL GUIDANCE FOR COUNSEL ON DUE DILIGENCE

In the case of In re Withrow, 391 B.R. 217 (Bankr. D. Mass 2008) the Bankruptcy Court defined the framework for the due diligence expectations for debtor's counsel. To test the reasonable person standard under Rule 9011 and Section 707(b)(4)(c) the Court determined that the following questions must be answered:

1. Did the attorney impress upon the debtor the critical importance of accuracy in the preparation of documents to be presented to the court?
2. Did the attorney seek from the debtor and then review whatever documents were within the debtor's possession, custody, or control in order to verify the information provided by the debtor?
3. Did the attorney employ such external verification tools as were available and not time or cost prohibitive (such as online real estate title compilations, online lien search, tax "scripts")?
4. Was any of the information provided by the debtor and then set forth in the debtor's court filings internally inconsistent? That is, was there anything that should have obviously alerted the attorney that the information provided by the debtor could not be accurate?
5. Did the attorney act promptly to correct any information presented to the Court which turned out, notwithstanding the attorney's best efforts, to be inaccurate?

These questions can be further simplified and reduced to one question, their common denominator: Did the attorney do his or her level best to get it right?

***Id.* at 228.**

Questions 1 and 2 emphasize the importance of gathering information from the client, which is among the first steps in any due diligence process, whether representing a debtor or a creditor.

Question 3, however, highlights a fundamental pillar of due diligence which is that legal practitioners cannot rely solely on the client's representations. Attorneys and paralegals should take additional steps to verify the information provided and confirm information such as any existing liens, whether liens are perfected, the status of any fixture filings, etc. For example, as creditor's counsel where your client may have a secondary lien, it's also a good idea to check on the primary lienholder's status. If the primary lienholder is not perfected, that is an opportunity to assert your client's superior position to the assets in question.

"One way to ensure that the execution of your due diligence framework is successful in bankruptcy is to work with a provider that can offer reliable turnaround times and accuracy."

DUE DILIGENCE IN DIP FINANCING

As a transactional attorney, you may question why lenders would lend money to a bankrupt company, but the competition for debtor-in-possession financing is fierce. The DIP usually needs cash immediately. Pre-bankruptcy assets are frozen, yet the company still needs cash to operate. Typically, continuing operations in Chapter 11 bankruptcy is the best way to maximize recovery for creditors.

Notable examples of bankrupt companies who have recently received DIP financing include Neiman Marcus ($400 million), 24 Hour Fitness ($250 million), and J.C. Penney ($450 million).

So why did these lenders come to the bankrupt companies' rescue, and how did they approach due diligence?

Pre-petition lenders may want to lend money to the debtor for a number of different reasons, which include the pre-petition lender being "undersecured" — funds being necessary to protect the going-concern value of the collateral, as well as the extensive benefits and protections offered to DIP lenders.

The first step in understanding due diligence in the context of DIP financing is to understand the incentives that draw in lenders. The second step is developing the due diligence framework for pre-closing and post-closing.

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BENEFITS FOR DIP LENDERS

How do DIP lenders benefit?

For one, DIP lenders can maximize recovery value by preserving the business as a going concern. Many businesses flourish after their debt is reorganized but allowing the ship to sink may mean that everyone loses.

Second, the lender can improve pre-petition claims by securing them with after-acquired assets, which are assets the debtor acquired after filing for bankruptcy. In addition, the lender may be able to get a lien on assets that are already encumbered by the lender for prior loans, a process that is called "cross-collateralization".

Third, being a DIP lender gives the lender more control over the bankruptcy case by giving the lender a right to include certain terms and conditions as part of obtaining the loan. For example, setting a deadline for the proposal of an acceptable plan of reorganization — or a deadline for sale of certain collateral — enables the DIP lender to move the bankruptcy process along.

PROTECTION FOR DIP LENDERS: SECTION 364

Given the credit risk of being a DIP lender, adequate compensation is needed. Section 364(c) of the Bankruptcy Code provides strong protections to such lenders. These include:

- granting a super-priority administrative claim (which will come ahead of all other administrative expenses),
- a lien on property of the estate that is currently unencumbered, or
- a junior lien on property of the estate that is subject to a lien.

If a debtor cannot be found on the above terms, Section 364(d) authorizes the court, after a notice and a hearing, to grant a "priming lien" that is senior or equal to a pre-existing lien on the property. In such a case, the pre-existing lienholder must be granted "adequate protection". Most creditors will seek protections under Section 364(d).

PRE-CLOSING LIEN DUE DILIGENCE

When representing a DIP lender, it's a good idea to conduct the same due diligence as if the deal took place outside of bankruptcy. Significant information may already be available on the public record within the bankruptcy case.

However, to minimize errors, you should avoid reliance on the due diligence of other parties – such as the debtor's counsel or trustee — and perform your own.

To ensure that the DIP lender gets first priority, it is important to perform searches on all the common liens — UCC, fixture filings, state and federal tax liens, as well as judgment liens. Depending on other factors, you may also want to consider performing litigation searches and other non-consensual lien searches.

Given that the debtor name on the UCC-1 must match the name of the debtor on the "public organic record" (as required by Section 9-503 of the UCC), it is likewise advisable to obtain copies of the debtor's formation documents and any related amendments. The formation documents will confirm the debtor's true legal name and capture any potential changes. It is your job to meticulously cross-reference this information so that your client's position as a DIP lender is secure.

If the business utilizes any business licenses — as many businesses do — it is best practice to identify and review key business licenses to ensure that they are kept up to date.

It is equally important to obtain a certificate of good standing from the debtor's state of formation and any jurisdiction where the debtor is qualified to do business, which will confirm that the debtor continues to pay its taxes remains in compliance.

Finally, if there is a guarantor involved, it is a good idea to perform all the necessary due diligence against the guarantor as well — lien searches, litigation searches — as well as confirm any other outstanding guarantees.

PERFECTION OF LIENS

What about perfecting liens in bankruptcy?

DIP Orders usually contain a provision stating that the DIP liens are perfected without further action under state law. This means that, as counsel for the DIP lender, you technically do not have to do anything else after the order is signed.

However, as the client's advocate, you may have concerns over enforcing validity of such liens in a forum outside of the Bankruptcy Court. A best practice is to complete the necessary collateral documentation and the required state filings. In the

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event you must prove priority or lien validity in the future, it's helpful to show evidence of perfection under the UCC.

When it comes to performing due diligence on DIP loans, it's best to follow the usual diligence procedures as you would outside of bankruptcy.

POST-CLOSING DUE DILIGENCE

Once the deal is signed, there are additional due diligence items on the checklist that must be addressed.

First and foremost, UCC-1s must be filed on any new liens. The filing must include the correct debtor name, secured party information, and collateral description.

If there are any fixture filings involved, the form should indicate (usually by checking a box) that the filing covers fixtures, including the description of the real property and the record owner name of the real property. This must be filed in the RE records — typically on the county level.

The debtor's name must also be continually monitored to capture any name change as it emerges from bankruptcy, either through acquisition or otherwise. Should the debtor change their name, you have four months to file a UCC-3 amendment to reflect the new debtor name or you risk losing priority. Likewise, should the debtor relocate to a new jurisdiction, a UCC-1 must be filed in the new jurisdiction within four months..

SECTION 363 SALES

It is typical for bankruptcy cases to involve the sale of the debtor's assets outside of the ordinary course of business. In a Chapter 11 case, this is conducted by the DIP, allowing the operating debtor more control over the process (as compared to a Chapter 7 where the sale is conducted by the bankruptcy Trustee).

Section 363 provides authority for such a sale and that the sale is free and clear of liens and other claims, subject to certain requirements.

The sale must be properly marketed and approved by the Bankruptcy Court. Secured lienholders usually may credit bid their claims. For example, if the secured party is owed $500,000 and the asset is worth $600,000, the secured creditor may bid its claim (without laying out cash). The first bidder is known as the stalking horse bidder, and that party has the most time to conduct due diligence.

Once the bidding process is underway, the Bankruptcy Court will typically set time limitations during which other bidders must complete their due diligence.

Although the stalking horse must lay all of its cards out on the table and be subject to very public negotiations, it enjoys the benefit of a break-up fee in the event another bidder is selected (usually about 3% of the price), or if the deal otherwise doesn't materialize..

DUE DILIGENCE CONSIDERATIONS FOR SECTION 363 SALES

Section 363 sales may encompass more than single assets such as equipment or real estate, but also sales of entire businesses or business divisions. Given this, certain due diligence considerations must be undertaken prior to bidding on the debtors' assets.

First, you must evaluate the collateral. Although the sale is free and clear of all liens, considerations should be given to certain types of claims that are not as clear-cut.

Example: Environmental claims

Are environmental liabilities fully discharged and disassociated from the assets? It depends. In *Ninth Avenue Remedial Group v. Allis-Chalmers Corp.*, 195 B.R. 716 (N.D. Ind. 1996), the Bankruptcy Court found that a sale order could not preclude any future environmental claims against the purchaser of the debtor's assets.

How can a buyer minimize any risk of such claims? One way is to run EPA searches and hire experts to determine if the property runs a risk of being subject to additional claims.

Example: Tort claims

Tort liabilities present another challenge. While the sale is not subject to existing claims, it may not necessarily prevent future claims.

To minimize this exposure, the buyer may want to consider running open and closed litigation searches to determine whether there are any other potential claimants out there based on the issues that had come up in the past.

By giving notice of the sale to as many parties as possible, the buyer would be able to minimize its exposure to future claims as such potential claimants would have had an opportunity to bring forward their claims prior to the sale..

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CONCLUSION

At first blush, it may seem that bankruptcy, with its own code and rules, is a very different world than most transactional attorneys are accustomed to.

However, there is significant crossover when it comes to lenders' due diligence. As discussed above, the due diligence best practices that are employed in non-bankruptcy transactions also ring true when it comes to DIP financing and Section 363 sales.

What is different is the procedural process and timing of bankruptcy cases — things typically move quicker. So it is important to understand the flow of the process and the applicable deadlines. One way to ensure that the execution of your due diligence framework is successful in bankruptcy is to work with a provider that can offer reliable turnaround times and accuracy.

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