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# Cross-Collateralization Clauses in Bankruptcy: Enforcement Challenges for Lenders

Resolving Lender Priority Disputes and Protecting Collateral in the Face of Dragnet Clauses

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# **CROSS-COLLATERALIZATION CLAUSES IN BANKRUPTCY: ENFORCEMENT CHALLENGES FOR LENDERS**

**Strafford CLE Webinar**

**By: Mark A. Bogdanowicz, Howard & Howard  
Richard A. Chesley, DLA Piper LLP**

**April 8, 2014**

# I. Introduction

## A. What is Meant by Cross-Collateralization?

- “Dragnet Clauses” – cover all of the borrower’s debts to the lender no matter when incurred
- “Future Advance Clauses” – cover debts that post-date the security agreement
- Found in mortgages and security agreements – often brought in by way of guaranties
- Loan being cross-collateralized – means that separate collateral pools serve as security for a given loan

## A. What is Meant by Cross-Collateralization? (cont-)

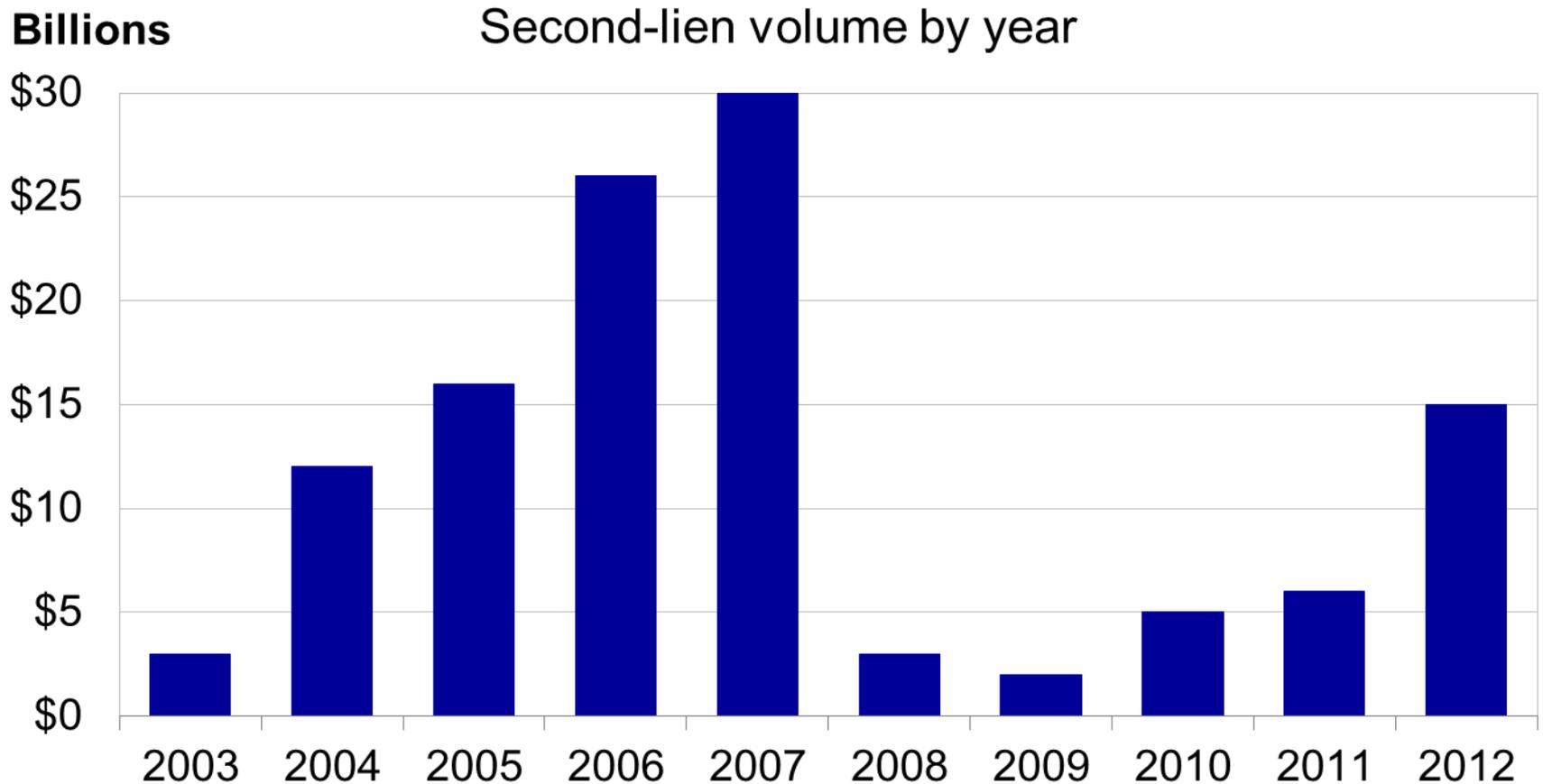
- Second lien financing often secured by liens on some or all of collateral securing first lien financing
- Second lien lender holds secured claims against borrowers
  - Not structurally subordinated, but rather subordinated through intercreditor agreements
- These intercreditor agreements, which are heavily negotiated, pose complex issues both inside and outside bankruptcy
- Second lien lender frequently limits its right to shared collateral, waiving many of its rights for the benefit of the first lien lender

## A. What is Meant by Cross-Collateralization? (cont-)

Difference is as follows:

- Standard Debt Subordination –
  - Subordinated lender would be required to turn over all payments received from borrower until first lien lender is paid in full
  - Claims of subordinated lender would be junior in priority to claims of unsecured creditors, including any unsecured claims of first lien lenders
- Second Lien Financing –
  - Depending on structure of intercreditor agreement, second lien lender typically limits its right to shared collateral only
  - If first lien lender is undersecured, second lien lender's claims would be senior to first lien lender's deficiency claim

## A. What is Meant by Cross-Collateralization? (cont-)



## B. What Sections of the Bankruptcy Code Apply?

### 1. Section 506(a) – Determination of Secured Status:

(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim ***to the extent of the value of such creditor's interest in the estate's interest in such property***, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim....

11 U.S.C. § 506(a)(1) (emphasis added)

## B. What Sections of the Bankruptcy Code Apply? (cont-)

### 2. Section 552 – Postpetition Effect of Security Interest:

(a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

11 U.S.C. § 552(a)

- Exceptions:

- Postpetition proceeds of pre-petition collateral – 11 U.S.C. § 552(b)(1)
- Revenues from hotels, motels, or other lodging properties – 11 U.S.C. § 552(b)(2)

## C. Application of Equitable Doctrines

### 1. Marshalling

- Concept – Creditor having two funds to satisfy debts should not be permitted to prejudice a junior creditor who may resort to only one of the funds
- Generally requires:
  - a. Two secured creditors of a common debtor
  - b. Two or more funds belong to that debtor
  - c. Senior creditor has right to resort to either or both, while junior creditor may only resort to one

## C. Application of Equitable Doctrines (cont-)

- **Limitations:** Application cannot be inequitable to senior creditor
  - a. Forced to pursue less liquid assets
  - b. Forced to pursue assets with uncertain value
  - c. Fund subject to more rigorous collection procedures

## II. Cross-Collateralization of Mortgages (Recent Notable Bankruptcy Decisions)

### A. Extent and Priority / Application of State Law As To The Scope of the Lien

1. *Peoples Nat'l Bank, N.A. v. Banterra Bank*,  
719 F.3d 608 (7<sup>th</sup> Cir. 2013)

- Adversary proceeding in individual chapter 11 case between lenders as to rights to surplus proceeds up to “Maximum Lien”
- Mortgage of senior lender contained general cross-collateralization provision
- Court held that actual notice of cross-collateralization clause in senior mortgage imparted inquiry notice of additional debts
- Court reasoned that Section 11 of Illinois Conveyances Act was permissive, not mandatory
- Scope of duty of inquiry was left unanswered

## A. Extent and Priority / Application of State Law As To The Scope of the Lien (cont-)

2. *Hari Aum, LLC v. First Guar. Bank (In re Hari Aum, LLC)*,  
714 F.3d 274 (5<sup>th</sup> Cir. 2013)

- Adversary proceeding regarding extent of mortgage containing cross-collateralization provision
- Multiple Indebtedness Mortgage (“MIM”) or “Collateral Mortgage” securing future obligations of the debtor (direct and guaranteed)
- Turned on the application of Louisiana state mortgage law
- Intervention and objection by the SBA as to Katrina relief loan made after initial loan, but before loan to related entity
- Corporate acknowledgment and reference to cross-collateralization in a new note were sufficient to support application of cross-collateralization
- Requirement under state law to explicitly state the maximum indebtedness secured

## B. Cross-Collateralization in Stay Relief Proceedings

### 1. *Magnolia Portfolio, LLC v. Dye (In re Dye)*,

502 B.R. 47 (Bankr. M.D. Penn. 2013)

- Individual chapter 11 debtor
- Six of seven loans had related mortgages with cross-collateralization provisions covering future advances
- On application of Pennsylvania “relatedness rule,” court held that one of the parcels securing one of the loans did not collateralize the remaining loans
- Court granted stay relief
- No equity to adequately protect interest of lender - 11 U.S.C. § 362(d)(1)
- Failure to make adequate protection payments was “cause” for stay relief as to all collateral subject to the cross-collateralization provision
- Stacking of loans to demonstrate lack of equity – 11 U.S.C. § 362(d)(2)

## C. Cross-Collateralization In Plan Confirmation (Chapter 12 Compared with Chapter 11)

1. *In re Chickosky*, 498 B.R. 4 (Bankr. D. Conn. 2013)

- Confirmation of joint chapter 12 plan of tobacco farm
- Multiple loans cross-collateralized by distinct parcels of real property and personal property
- Proposed plan provided to pay full amount of value of collateral, but eliminate cross-collateralization
- Court sustained lender's objection to confirmation and held that debtor could not use plan to modify cross-collateralization; can't alter lien in any way over the objection of secured creditor
  - Lien retention requirement in chapter 12 cases – 11 U.S.C. § 1225(a)(5)(B)(i)

## C. Cross-Collateralization In Plan Confirmation (Chapter 12 Compared with Chapter 11) (cont-)

2. *In re Bryant*, 439 B.R. 724 (Bankr. E.D. Ark. 2010)

- Confirmation of individual chapter 11 debtors' plan
- FSA had a first lien on personal property and a cross-collateralized junior lien on personal residence
- Debtor proposed plan containing a lump-sum cash payment on effective date equal to the "value" of the junior lien and a release of lien
- Court confirmed plan over objection of FSA on the grounds that it had received the "indubitable equivalent" of its junior lien right
- No lien retention requirement in chapter 11 cases – 11 U.S.C. § 1129(b)(2)(A)(iii)

### III. Issues / Best Practices

#### A. Single Lender

- Review the state law of the potentially-applicable jurisdictions
- Choice of law for most favorable jurisdiction as to cross-collateralization
- Identify the specific debts to be cross-collateralized, whenever possible

## B. Multiple Lenders

### 1. Extent of Cross-Collateralization

- Identify duration of agreed inter-creditor priority and triggers for termination of subordination (e.g., continuation after payoff of senior indebtedness)
- Include covenant against cross-collateralization of junior debt, especially if senior debt is being subordinated
- If covenant against cross-collateralization not feasible, be sure to include caps on junior debt, especially if senior debt is being subordinated
- Obtain reps and warranties as to all current documents evidencing lending relationship
- Identify collateral pool that is receiving priority under inter-creditor agreement

## 2. Modification of Rights and Remedies

- Make creation of additional secured debt an event of default on senior loan documents
- Require permission by or notice to senior lender of each extension of credit by junior lender and/or draw by borrower
- Restrict cross-default by junior lender
- Require payment subordination (“payment restriction”) (i) while outstanding obligations on senior indebtedness or (ii) upon event of default under senior loan

## 2. Modification of Rights and Remedies (cont-)

- Require lockbox on all payments, junior and senior
- Include standstill agreement regarding enforcement rights of junior lender (or limitation upon duration of standstill if senior debt being subordinated to new loan)
- Limit and/or require notice of any loan document modifications
- Require waiver of marshalling and subrogation
- Include clarifying provision that all terms regarding rights and remedies apply to future advances and place no limit upon future advances by senior lender

## 2. Modification of Rights and Remedies (cont-)

- No participation in or consent to workout or settlement negotiations between senior and borrower upon event of default by borrower
- Include provisions addressing retention of liens or application of proceeds upon disposition of collateral
- Consider the impact of a refinancing upon the respective rights of parties
- Limitation upon assignment of junior lien without assignee joining in inter-creditor agreement

### 3. Intercreditor Agreements

- Primary purpose is to act as shield for first lien lender against the actions of a second lien lender
- Balance of negotiating power between first lien lender and second lien lender
- The Intercreditor Agreement sets out the rights of each lender group in relation to the other to the pledged assets in the event the borrower defaults on its debt repayment obligations or files for bankruptcy

### 3. Intercreditor Agreements (Key Provisions)

- Defining the Common Collateral
- Standstill Periods
- Structuring Indebtedness Caps
- Drag Along with Lien Release
- Purchase Options
- Rights as Unsecured Creditor
- Insolvency Provisions

### 3. Intercreditor Agreements

#### A. Defining Common Collateral

- The role of the Intercreditor Agreement is to create the relative rights of the First Lien and Second Lien Lenders in common collateral
- A problem arises when the First Lien Lender, against the expectations of both parties, does not have a valid and perfected lien over some or all of the common collateral
- Intercreditor Agreements are drafted to take one of two approaches:
  - Absolute Priority Rule: The First Lien Lender's lien priority extends to all assets that the first lien lender's security agreement defines as collateral, regardless of whether valid and perfected liens exist
  - Relative Priority Rule: Common collateral limited to those assets over which valid and perfected liens exist

### 3. Intercreditor Agreements

#### A. Defining Common Collateral (cont-)

- Example provision where a perfected lien is not required:
  - Language establishes the priority of each lender groups' liens "notwithstanding the date, manner or order of grant attachment or perfection of any Liens . . . and **notwithstanding** any provision of the UCC, any other applicable law or . . . **any defect or deficiencies in, or failure to perfect or lapse in perfection of**, or avoidance as a fraudulent conveyance or otherwise of, **the Liens.**"
- Example provision where a perfected lien is required:
  - Language establishes the priority of each lender groups' liens "**to the extent valid, perfected, enforceable and not avoided**, and, in each case, irrespective of the time or manner of perfection" of the Liens

### 3. Intercreditor Agreements

#### A. Defining Common Collateral (cont-)

- In addition, intercreditor agreements often contain provisions prohibiting each lender group from contesting the validity of the other group's liens:
  - "Each [Secured Party] agrees that it will not, and hereby waives any right to, contest or support any other Person in contesting, in any proceeding (including any Insolvency Proceeding), the priority, validity or enforceability of any Junior Lien or any Senior Lien, as the case may be; provided, that nothing in this Intercreditor Agreement shall be construed to prevent or impair the rights of [any Secured Party] to enforce this Intercreditor Agreement or their rights hereunder."

### 3. Intercreditor Agreements

#### B. Standstill Provisions

- The Standstill Provision is one of the most important provisions in an Intercreditor Agreement
- The Standstill Provision prevents a Second Lien Lender from taking any enforcement action against the collateral for a specified period of time
- From the First Lien Lender's perspective, it allows an opportunity to consider whether to pursue its own enforcement remedies against the collateral without interference from the Second Lien Lender
- Second Lien Lenders worry about being stopped from taking any action for an extended period of time, especially if the common collateral is declining in value
- The Second Lien Lenders bears the full amount of any decline in the value of the collateral until it does not yield enough proceeds to pay the First Lien Lender

### 3. Intercreditor Agreements

#### B. Standstill Provisions (cont-)

- Often, the Intercreditor Agreement will provide that the Second Lien Lenders may not exercise their rights and remedies unless or until the First Lien Lenders have been paid in full – thus establishing a permanent "standstill period"
- Some Intercreditor Agreements, however, provide that, in the event of a default under the Second Lien Loan Documents, the Second Lien Lenders may provide a notice to the First Lien Lenders of their intent to exercise their rights and remedies
  - This triggers a temporary standstill period before the Second Lien Lenders can proceed
  - The length of this standstill period varies
- In addition, some agreements provide that the standstill period tolls during any insolvency proceeding or enforcement action by first lien lenders and resumes thereafter

### 3. Intercreditor Agreements

#### C. Indebtedness Caps

- Given that Intercreditor Agreements govern the relative lien priority of two security interests which secure different debt obligations, it is important for the holders of each debt obligation to know the extent of the other debt
- Second Lien Lenders often seek to negotiate caps on the total outstanding indebtedness to the First Lien Lenders in order to ensure that Second Lien Lenders maintain appropriate collateral coverage
- First Lien Lenders, however, want to retain flexibility so that additional obligations may be added to the amount of the First Lien Debt while still retaining the benefit of lien priority
  - Anticipate that Borrower may need to borrow additional amounts to satisfy a liquidity shortfall or capitalize on business opportunity

### 3. Intercreditor Agreements

#### C. Indebtedness Caps (cont-)

- Typically, the cap takes two forms:
  - An explicit cap placed on total outstanding obligations secured by the senior lien
  - A limitation on amendments having the effect of increasing first lien loans
- Additional considerations:
  - A subset of agreements explicitly provide that, above the cap, the liens securing the excess obligations move to the end of the priority waterfall

### 3. Intercreditor Agreements

#### D. Drag Along with Lien Release

- As part of their preferential enforcement rights over common collateral, First Lien Lenders typically want the right to force Second Lien Lenders to release their liens on assets that are being sold
- This is important so that Second Lien Lenders cannot delay or impede a sale of collateral to a third party that will generate proceeds to pay off the outstanding First Lien Debt

### 3. Intercreditor Agreements

#### E. Purchase Options

- Some Intercreditor Agreements include provisions allowing the Second Lien Lender to purchase the First Lien Lender's loans
- Second Lien Lenders generally look to the enterprise or going concern value of the borrower's business that there are sufficient proceeds from the collateral to repay their loans
- First Lien Lenders may have different views on how important it is to take certain steps to maximize the value of the collateral
- First Lien Lenders may prefer getting paid quickly and in full rather than taking the extra time to enhance the value of the collateral for the benefit of Second Lien Lenders
- Second Lien Lenders, on the other hand, may feel that a sale of the borrower's assets or other reorganization that is organized by the Second Lien Lenders will maximize value and their recoveries
- A solution to this issue is to give Second Lien Lenders the right to purchase the First Lien Lender's claims

### 3. Intercreditor Agreements

#### F. Rights as an Unsecured Creditor

- Intercreditor agreements typically limit junior creditors' rights as secured creditors but provide that junior lenders may enforce their rights and remedies as unsecured creditors
  - "Each Secured Party may, in accordance with the terms of the applicable Debt Documents and applicable law, enforce rights and exercise remedies against Holdings and any other Grantor as unsecured creditors; provided, that no such action is otherwise prohibited by the terms of this Intercreditor Agreement."
- Where an agreement preserves parties' rights as unsecured creditors, it generally provides that such rights are limited by the terms of the intercreditor agreement
  - "Each Secured Party may, in accordance with the terms of the applicable Debt Documents and applicable law, enforce rights and exercise remedies against Holdings and any other Grantor as unsecured creditors; provided, that no such action is otherwise prohibited by the terms of this Intercreditor Agreement."

### 3. Intercreditor Agreements

#### G. Insolvency Provisions

- A primary purpose of Intercreditor Agreements is to establish the parties' rights should the borrower file for bankruptcy
- As a result, Intercreditor Agreements have a section setting forth certain limits on the actions Second Lien Lenders can take in a bankruptcy case, including:
  - Limiting the Second Lien Lender's right to challenge the validity of the First Lien Lender's liens
  - Limiting Second Lien Lender's rights to object to DIP financing where the senior lenders are providing or support the provider of such financing
  - Limiting Second Lien Lender's rights to request adequate protection
  - Limiting Second Lien Lender's rights to object to requests for adequate protection by First Lien Lenders
  - Restrictions placed on voting rights as a secured creditor to approve or object to a proposed Plan of Reorganization of a Borrower

### 3. Intercreditor Agreements

#### G. Insolvency Provisions (cont-)

- In addition, many intercreditor agreements also include restrictions on junior creditors' rights to object to sales of collateral under Bankruptcy Code section 363 or to take other actions or file other motions or objections which would contravene the terms and priority scheme established by the intercreditor agreements, including but not limited the rights of first lien lenders to credit bid their debt

## 4. Cross-Collateralization in DIP Context

- Post-petition lender, who is also a prepetition creditor (usually secured lender) requires, as a condition for DIP financing, secures the entire amount of prepetition indebtedness with all of the debtor's postpetition assets
- Most drastic effect occurs when prepetition lender is substantially undersecured
- Takes section 363(e) of Bankruptcy Code (post-petition collateral used by debtor entitles lender to replacement lien on debtor's other assets) to the extreme
- Indeed section 552 continues a lien under a prepetition security agreement only in collateral in existence on the petition date

## 4. Cross-Collateralization in DIP Context

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- Indeed section 552 continues a lien under a prepetition security agreement only in collateral in existence on the petition date
  - The 11<sup>th</sup> Circuit has held that such "forward cross-collateralization DIP financings are not permissible to the extent that it provides additional security for an undersecured prepetition loan

## 4. Cross-Collateralization in DIP Context (cont-)

- Post-petition lender, who is also a prepetition creditor (usually secured lender) requires, as a condition for DIP financing, secures the entire amount of prepetition indebtedness with all of the debtor's postpetition assets
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## 4. Cross-Collateralization in DIP Context (cont-)

- The 11<sup>th</sup> Circuit has held that such “forward cross-collateralization DIP financings are not permissible to the extent that it provides additional security for an undersecured prepetition loan
- Other courts allow, under certain circumstances, attempts to forward cross-collateralize
- Following four factors, first analyzed in *In re Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983), most widely adopted:
  1. Absent the proposed financing, would the debtor’s business operation survive?
  2. Is the debtor unable to obtain alternative financing on acceptable terms?
  3. Will the proposed lender agree to less preferential terms?
  4. Is the proposed financing in the best interest of the general creditor body?

## **IV. DIP Cross-Collateralization Case Study - Orchard**

- On June 17, 2013, Orchard Supply Hardware filed voluntary petitions, involving three separate debtor entities: Orchard Supply Hardware Stores Corporation (HoldCo), Orchard Supply Hardware LLC (OpCo) and OSH Properties LLC (PropCo)
- Prior to bankruptcy filing, Orchard had a first lien revolving credit and asset-backed loan facility (“ABL”), and a term loan facility (“Term Loan”)

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- ABL facility had a first lien on substantially all of the assets of HoldCo and OpCo, while Term Loan facility had junior lien on this collateral and a first lien on debtor's furniture, fixtures and equipment
- PropCo was unencumbered at time of bankruptcy filing
  - Held approximately \$50 million of unencumbered value

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- Term Loan lenders expressed strong desire to acquire the company’s assets under a sale pursuant to Section 363 of the Bankruptcy Code
  - Yet, they held only a first lien on approximately \$5 million of FF&E
- In order to effectuate a purchase through “credit bidding” their secured debt under section 363(k), they would need to:
  1. Obtain consent from ABL facility lenders, or receive rights through amendment to Intercreditor Agreement
  2. Obtain a lien on unencumbered assets of PropCo

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- At same time while discussions were ongoing with ABL facility lenders and Term Loan lenders, Orchard was negotiating a stalking horse Asset Purchase Agreement with Lowe's
- The company was highly desirous of obtaining a full roll-up DIP facility from the ABL facility lenders to as to provide its skittish customers and vendors with ample liquidity to survive the uncertainties of Chapter 11
- The company strongly preferred selling its assets to a strategic buyer rather than its lenders

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- On date of bankruptcy filing, a Plan Support Agreement and amended Intercreditor Agreement were executed, containing the following terms:
  1. ABL Facility lenders would provide a full roll-up DIP facility of \$165 million, with the required consent of the Term Lenders under the Intercreditor Agreement
  2. Term Lenders would provide supplemental \$12 million tranche of DIP financing
  3. Term Lenders would consent to Lowe's stalking horse purchase and would receive consent of ABL Facility lenders to credit bid in an auction under certain limited circumstances
  4. The Debtors would provide superpriority DIP liens and junior priority DIP liens on the previously unencumbered assets of PropCo

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- If granted, would shift \$50 million value away from general unsecured creditors to secured lenders
- On July 15, 2013, following an extensive evidentiary hearing, Judge Sontchi approved the DIP financing, including the cross-collateralization provisions
- “I do think and do find that the sale to a third-party nonlender is the best path forward . . . [and t]hat sale, to get their required liquidity that the debtor needed, that the debtor was only able to get out of [the ABL lender who] was only willing to provide the liquidity to the extent it was going to get additional collateral, or improve its collateral position; and the term lenders who had that position or had a blocking position were only willing to do so if they could get cross-collateralization in connection with their DIP”

## IV. DIP Cross-Collateralization Case Study – Orchard (cont-)

- Judge Sontchi noted that he was “very, very, very reluctant to approve that kind of relief” and yet, “in this unique set of circumstances,” he overruled the objections and approved the DIP financing
- Had a drastic impact on general unsecured creditors; however, it is significant to note that the Lowe’s stalking horse purchase provided for the assumption of more than \$50 million in prepetition trade liabilities

# Thank You

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