Critical Vendors
DIP Lenders
Incentive Conflicts
Renegotiation

Credit and Contracts

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Organizing Themes

A modern corporation is best viewed as a nexus of contracts.

We see in the Kmart case what happens when a corporation cannot meet its contractual obligations. By mid-January 2002 factoring firms were no longer extending credit to Kmart's suppliers.

On 1/21/02 Fleming Companies announced that it was no longer making deliveries to Kmart –who missed a payment the previous week.

Bankruptcy

Kmart filed for Chapter 11 protection on 1/22/02.

Along with the filing, Kmart filed a first day motion seeking the court's authority to pay *critical* vendors. Kmart's claim is that these are essential to Kmart's day-to-day operations. Such "critical vendors" included:

- Fleming Companies (virtually all food items);
- Handleman Company (music);
- Suppliers of egg and dairy products;
- Newpapers and other vendors related to Kmart's advertising.

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Critical Vendors

The bankruptcy court agreed with Kmart's CEO that *full* payment to these critical vendors was essential to Kmart's ongoing success.

Pursuant to this motion Kmart paid 2,330 suppliers $300 million in full satisfaction of prepetition debts. By contrast, another 2,000 vendors deemed "not critical" were not paid.

An issue we want to review here is how under bankruptcy two claimants who are identical pre-petition are treated differently under bankruptcy.

Critical Vendors

Capitol Factors is a factoring agent for several Kmart apparel vendors who were not deemed critical vendors. (Note that under the reorganization plan such vendors received some stock and joined a creditor trust – estimated recovery rate of 10%.) Capitol appealed the bankruptcy court's decision to a District Court.

The District Court agreed with Capitol Factors and overruled the bankruptcy court. The Seventh Circuit court affirmed the District Court.

After the resolution of all of this, courts are now much more skeptical of critical vendor payments.

DIP and the Crisis

Prior to the financial crisis of 2008 GE Capital was the dominant DIP lender. At the onset of the crisis GE Capital quit the business–just as bankruptcies were proliferating.

As Shields discusses, in this environment, “the terms of DIP lending have become more demanding.”

Of particular interest is the ability to roll-up prepetition financing debt into the DIP facility. (This seems bizarre to me – courts must feel that such arrangements are necessary in the context of the financial crisis.

Costly State Verification

Why do lenders provide debt financing, adnd why do companies obtain capital using debt?

One theoretical argument notes that when it is costly to ascertain a firm's value then debt reduces the state space to just 2 – either the borrower pays back or does not.

"Debt aligns the incentives between the borrower and lender because of the costs that lenders may impose on borrowers in default. (It is in the borrower's best interests to pay back the loan if its value exceeds the face value.)

Control Rights

Consider the Kmart case. Does it make any sense that Kmart declared bankruptcy for the purpose of trying to rip off its lenders? Probably not:

- The CEO is fired.
- "Control Rights" shift from shareholders and their agents (managers) to lenders.

DIP and Control

From Skeel (2004):

> *By structuring the [DIP] loan as a revolving credit agreement and imposing strict conditions on each new round of financing, the lender is assured that it will have significant leverage over the debtor's managers' decision-making throughtout the Chapter 11 process.*

Conflicts under Chapter 11

Roberts and Sufi note that under the current bankruptcy environment, “the relevant conflict is between [not managers and lenders, but] secured and unsecured creditors.”

Think of the designation of *critical vendors* in the Kmart case. Recall that a higher court overruled the bankruptcy judge’s granting of this status to a subset of vendors.

Rollover provisions in debt financing raise similar concerns within the same class of pre-petition lenders.

Renegotiation

In an empirical study of bank loans, Roberts and Sufi find that renegotiation of the terms is almost universal – 90% of loans' terms are renegotiated – outside of bankruptcy.