

## DIP Financing Agreements

### *The Effect of Pre-Petition Indemnification Provisions*

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In filing for bankruptcy, one of the most important decisions a debtor makes is with regard to debtor-in-possession (DIP) financing. Typically, a debtor negotiates with its pre-petition lender, which then finances the Chapter 11 case. In return, the lender is granted certain protections from the debtor, ranging from superpriority administrative expenses to adequate protection replacement liens to indemnification of the lender under certain circumstances.

The usual DIP financing indemnification provision applies only to the post-petition financing agreement. However, some lenders have insisted upon indemnification for pre-petition acts as well. This article examines the typical DIP financing indemnification provision and the less frequently seen pre-petition indemnification provision, and discusses the effect of pre-petition indemnifications on the bankruptcy estate.

#### TYPICAL INDEMNIFICATION PROVISIONS

Not all DIP financing agreements have indemnification provisions. For those agreements that do contain

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indemnification provisions, a debtor must usually indemnify the lender and hold it harmless from losses, claims or expenses that the lender may incur with respect to the DIP financing agreement and related documents. See, e.g., *In re N.Y. Chocolate & Confections Co.*, 10-30963 (Bankr. N.D.N.Y.), ECF No. 8-1; *In re Bedford Commc'ns, Inc.*, 10-10902 (Bankr. S.D.N.Y.), ECF No. 7-1; *In re WorldSpace, Inc.*, 08-12412 (Bankr. D. Del.) ECF No. 87-1, 87-2, 87-3.

#### INDEMNIFICATION FOR PRE-PETITION CONDUCT

At least three cases in recent years have extended lender indemnification to pre-petition conduct. However, the indemnification provisions in each were accomplished in different ways.

The DIP financing agreement in *In re Ames Department Stores, Inc.* provided that certain pre-petition letters of credit were to continue under the DIP financing agreement, essentially rolling all pre-petition obligations into the post-petition obligations. *In re Ames Dept. Stores, Inc.*, et al., 01-42217 (Bankr. S.D.N.Y.), ECF No. 6-1. These obligations were subject to further terms, including an indemnification provision that provided that the debtors:

shall jointly and severally indemnify and hold harmless each of [the lenders] ... from and against any and all suits, actions, ... and expenses ... that may be instituted or asserted against or incurred by any such Indemnified Person as the result of credit having been extended ... and in connection with or arising out of the transactions contemplated

hereunder and thereunder ... arising out of or incurred in connection with disputes between or among *any parties* to any of the Loan Documents ...

*Id.* at § 1.13.

Similarly, in *In re Crdentia Corp.*, the debtors and the pre-petition lender entered into a ratification of the pre-petition credit agreement in lieu of a newly executed post-petition agreement, *In re Crdentia Corp.*, et al., 10-10926 (Bankr. D. Del.), ECF No. 28-4, and the debtors and the lender jointly entered into a cash collateral budget. *Id.*, Ex. C. The pre-petition agreement provided for indemnification of the lender against, among other things, any and all claims and losses connected with the use of the proceeds of the loans and any litigation relating to the loans, except for expenses arising from an unexcused breach of the agreement or willful misconduct or gross negligence of the lender. *Id.*, Ex. A § 9.2.

Finally, in *In re Giordano's Enterprises, Inc.*, the DIP financing order entered by the court provided, among other things, that the debtors "shall indemnify and hold harmless [the lender] in accordance with the Postpetition Credit Agreement and the Prepetition Credit Agreement." *In re GEI-RP*, 11-06098 (Bankr. N.D. Ill.), ECF No. 103 at ¶ 15. The DIP financing agreement provided for an indemnification for actions relating to pre-petition indebtedness, including:

any and all losses, claims, ... and related costs and expenses, including without limitation, reasonable counsel fees and expenses, ... arising out of any claim,

action, suit, litigation, investigation or proceeding ... which may be imposed on, incurred by, or asserted against any Indemnified Person ... in any manner relating to or arising out of this Agreement, the Related Documents, or any act, event or transaction related or attendant hereto or thereto ... provided, however, that such indemnity shall not apply to any such losses, claims, damages, or liabilities or related expenses determined by a court of competent jurisdiction to have arisen from the gross negligence or willful misconduct of such Indemnified Person.

*Id.*, Ex. A § 7.2(r), ECF No. 9-1. "Related Documents" included any documents executed in connection with the "Indebtedness."

*Id.* at ¶ 7.1.

"Indebtedness" was defined as including the debts under the pre-petition credit agreement. *Id.* Though no objection had been raised at the time that the DIP financial motion was considered, at a subsequent hearing on a related adversary proceeding, Judge Eugene R. Wedoff stated that the indemnification provision in the DIP financing agreement "trouble[d] him greatly," *Gesas v. Apostolou*, Adv. No. 11-02477 (Bankr. N.D. Ill.), ECF No. 23 at p. 5, and that had it been brought to his attention at the time he would have refused to enter the order, as "[t]here is simply no reason why, as a condition for getting post-petition lending, a debtor should incur an indemnification obligation for activity of the lender that had nothing to do with the post-petition lending ... ." *Id.* at p. 7. Judge Wedoff's comments suggest that, at the least, courts disfavor pre-petition indemnification provisions and, perhaps, may be amenable to a challenge of such a provision.

#### EFFECT OF PRE-PETITION

#### INDEMNIFICATION ON THE

#### BANKRUPTCY ESTATE

Pre-petition indemnification provisions are uncommon in DIP financing agreements, perhaps because such provisions can have a detrimental effect

on the bankruptcy estate and its creditors, and can affect other aspects of the case as well.

For example, in *Ames*, the pre-petition indemnification substantially affected the pool of assets available to general unsecured creditors. LFD Operating, Inc. commenced an action in state court against GE Capital Corporation (GECC), the DIP lender, for the return of certain proceeds that LFD claimed GECC improperly received from the debtors pre-petition. *LFD Operating, Inc. v. Gen. Elec. Cap. Corp. (In re Ames Dept. Stores, Inc.)*, Case No. 06 CV 5394, 2008 WL 7542200, at \* 1 (S.D.N.Y. June 4, 2008). The debtors and GECC disagreed as to whether GECC was entitled to indemnification in the LFD litigation; ultimately, the debtors and GECC stipulated to establish an escrow account in the amount of \$11,500,000 for litigation costs. ECF No. 1217.

In examining whether the bankruptcy court had core jurisdiction over the litigation, the District Court for the Southern District of New York explained that the indemnification issue had a significant impact on the estate's administration, given that the substantial amount of funds to be set aside for the action called into question the estates' administrative solvency. *Id.* at \*7. Thus, not only did the pre-petition indemnification provision affect the administrative solvency of the bankruptcy estate, but it also factored heavily into whether the bankruptcy court had core jurisdiction over the litigation.

In *Giordano's*, the estate funded the litigation costs of the DIP lender, Fifth Third Bank (Fifth Third), in a state court lawsuit filed against Fifth Third by the former principals of the debtor based upon certain alleged pre-petition misdeeds. GEI-RP, ECF No. 1203, at ¶ 12.

Having already reimbursed over \$100,000 of Fifth Third's litigation costs, and in light of the risk of substantial additional reimbursement obligations, the Chapter 11 trustee filed a motion to settle certain claims associated with the former principals by, among other things, transferring to the former principals cash and real property having an aggregate value in excess of \$2 million. *Id.* ¶¶ 18, 20, 21 24 & 34.

In exchange, the principals agreed to release their claims against the estate and against Fifth Third with respect to the state court action, thereby relieving the estate of future indemnification obligations, except for an additional \$200,000 should a non-released defendant bring Fifth Third back into the litigation. *Id.* at ¶ 24.

At the time of the settlement motion, the estate had approximately \$4 million in cash, and expected to receive an additional \$1.3 million from liquidation of remaining estate assets. *Id.* at ¶ 10. The Chapter 11 trustee estimated that the net assets available for unsecured creditors was approximately \$3.8 million. *Id.*

The Official Committee of Unsecured Creditors filed a motion to determine the scope of the indemnification provision and an objection to the settlement motion, alleging, among other things, that the indemnification was unenforceable — in that the claims asserted against Fifth Third were based on alleged willful misconduct — and that a settlement that diverted substantial estate value to the former principals was improper on its face. The court denied the motion and overruled the objection, approving the settlement motion on grounds that notwithstanding the less than exemplary conduct of the principals, the settlement payment represented an appropriate exercise of the trustee's business judgment.

#### CONCLUSION

In light of the adverse effects that a pre-petition indemnification provision can have on a bankruptcy estate, debtors should carefully consider whether such a provision is in the best interest of the estate, and creditors and creditors' committees should pay careful attention to proposed DIP financing agreements containing such provisions.

