

Emerging Professionals Panel: Show Me the Money — Understanding, Structuring and Getting Approval for Debtor-in- Possession Financing

Natalie B. Sawyer, Moderator

U.S. Bankruptcy Court (D. Mass.); Springfield

Eric A.W. Danner

Deloitte CRG; Boston

Julia Frost-Davies

Morgan, Lewis & Bockius LLP; Boston

Anne Marie Dirsra

Office of the U.S. Trustee; New York

D. Ethan Jeffery

Murphy & King, PC; Boston

Hon. Elizabeth S. Stong

U.S. Bankruptcy Court (E.D.N.Y.); Brooklyn

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Practical Realities

First Days After Filing

- ☐ When a business files a chapter 11 bankruptcy, it is generally authorized to continue to operate its business. 11 U.S.C. § 1108.
- ☐ But operating a business requires cash, and most Debtors must come to court to gain access to cash for operations immediately after filing the case.

Debtors Obtain Cash Two Ways

- ☐ There are generally two means for a Debtor to get access to cash necessary to operate its business post-petition:
 - authorization to use cash collateral
 - Debtor-in-possession (DIP) financing (post-petition credit)
- ☐ Because of the almost immediate need for cash, most Debtors seek emergency or expedited consideration of cash collateral or DIP financing.

DIP Financing – Post-Petition Credit

- ☐ 11 U.S.C. § 364 governs post-petition credit
 - 364(a) allows credit in the ordinary course of business as admin expense, *e.g.*, the vendor/supplier with invoice terms of net 30
 - 364(b) administrative priority for post-petition lending (rarely used because most post-petition lenders want the protections of 364(c) and (d))
 - 364(c) superpriority administrative claim, lien on unencumbered assets, junior lien on encumbered assets
 - 364(d) senior (priming) or equal lien on encumbered assets
- ☐ Section 364 also generally requires that debtor show that financing is not available using lower priority protections to lender.
- ☐ Some DIP lending will take out original prepetition lender, and some will be in addition to prepetition lending. DIP lender is sometimes the prepetition lender. This requires consideration of other issues addressed later (*e.g.*, roll ups, cross collateralization).

DIP Loans from the Debtor's Perspective

Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons useable against it for the bankruptcy estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization, and steal a march on other creditors in numerous ways. The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specifically crafted for the benefit of the Bank and the Debtors' principals who guaranteed its debt.

In re Tenney Village Company, Inc., 104 B.R. 562, 568 (Bankr. D.N.H. 1989).

- ☐ Except for vendors who provide trade credit in the ordinary course of business, it is unusual to find a third party who is prepared to lend money to a debtor on an unsecured basis. Consequently, most DIP loans involve the granting of liens on the debtor's property, or involve loans from insiders, or both. Because debtors are frequently in desperate need of the DIP loan, DIP lenders tend to have substantial leverage in negotiating the terms of the DIP loan. The job of debtor's counsel is to preserve as much of the bankruptcy estate's rights while still obtaining the DIP loan, often in circumstances where the decision makers for the debtor have personal interests at risk, such as personal guaranties and interests in non-debtor co-obligors of the debtor.
- ☐ Start from the end of the case and work backwards – how does the DIP loan fit into the overall goal of the case? Without knowing this, you cannot explain to the Court, the United States Trustee (the "UST") and creditor constituencies why it makes business sense to obtain the DIP loan.
 - Does the case involve a reorganization? If so, who will be the ultimate owner of the company, existing equity, debt holders converting their debt to equity, a third party buyer of the equity?
 - Was the case filed to effectuate a going concern sale? If so, who is the buyer, the secured creditor, existing equity or a third party?
 - Is the case a structured liquidation?

DIP Loans from the Debtor's Perspective

What is the purpose of the DIP loan?

- ☐ Is it a bridge loan to cover short term cash flow issues?
- ☐ Is it necessary to fund operating losses while a going concern sale is completed?

Who is the DIP lender and who else benefits from the DIP loan?

- ☐ The existing secured creditor(s)?
- ☐ A third party lender?
- ☐ Insiders?

What are the financial terms of the DIP loan (interest rate and fees)?

How and when will the DIP loan be repaid?

- ☐ Can it be re-paid from cash flow?
- ☐ What is the term of the DIP loan?
- ☐ Are there mandatory pay downs?
- ☐ Are there reserves?
- ☐ Will it be repaid by exit financing?
- ☐ Will it be repaid upon the sale of collateral?

Strategic Considerations

☐ What form will the DIP take?

- Full or partial refinancing
- Priming
- Roll-Up
 - Full roll
 - Partial Roll
 - Creeping roll

Strategic Considerations

☐ Intercreditor/Interlender Issues

- Intercreditor agreement
 - Adequate protection
 - Drag-alongs
 - Ability to provide financing
 - Maximum debt caps/priorities
- First lien/Second lien
- Bifurcated collateral
- Unitranche

Strategic Considerations

☐ The DIP Loan Documents

- Differences in Credit Agreement between pre-petition and DIP financing
 - Conditions precedent
 - Reps and warranties
 - Negative covenants/use of proceeds
 - Financial covenants and reporting requirement
 - Events of default
 - Overall tightening of provisions
- Fee agreements
- Perfection documents

The Post-Petition Process

Rule 4001(c)

☐ Motion required and must include or attach:

- Credit agreement
- Proposed order
- Summary of all material provisions of credit agreement and proposed order, including where the provision may be found, including:
 - interest rate
 - maturity
 - events of default
 - liens
 - borrowing limits
 - borrowing conditions

- ### ☐ Generally, a court will allow a single motion to provide for both interim and final relief

The Post-Petition Process

Rule 4001(c) — cont'd

- ❑ Rule 4001(c) also identifies eleven types of relief that must be specifically identified in the motion if in the credit agreement or proposed order:
 - (i) a grant of priority or a lien on property of the estate under §364(c) or (d)
 - (ii) the providing of adequate protection or priority for a prepetition claim, including the granting of a lien on property of the estate to secure the claim, or the use of property of the estate or credit obtained under § 364 to make cash payments on account of the claim
 - (iii) a determination of the validity, enforceability, priority, or amount of a claim that arose before the commencement of the case, or of any lien securing the claim
 - (iv) a waiver or modification of Code provisions or applicable rules relating to the automatic stay
 - (v) a waiver or modification of any entity's authority or right to file a plan, seek an extension of time in which the Debtor has the exclusive right to file a plan, request the use of cash collateral under § 363(c), or request authority to obtain credit under § 364

The Post-Petition Process

Rule 4001(c) – cont'd

- (vi) the establishment of deadlines for filing a plan of reorganization, for approval of a disclosure statement, for a hearing on confirmation, or for entry of a confirmation order
- (vii) a waiver or modification of the applicability of nonbankruptcy law relating to the perfection of a lien on property of the estate, or on the foreclosure or other enforcement of the lien
- (viii) a release, waiver, or limitation on any claim or other cause of action belonging to the estate or the trustee, including any modification of the statute of limitations or other deadline to commence an action
- (ix) the indemnification of any entity
- (x) a release, waiver, or limitation of any right under § 506(c)
- (xi) the granting of a lien on any claim or cause of action arising under §§ 544, 545, 547, 548, 549, 553(b), 723(a), or 724(a)

The Post-Petition Process

Rule 4001(c)

- ☐ Court may conduct preliminary or interim hearing within 14 days after service, but only authorize that which is necessary to avoid “immediate and irreparable harm” pending the final hearing
 - Examples of irreparable damage commonly approved for interim cash collateral use are employee wages, purchase of necessary supplies, and insurance.
- ☐ Final hearing must be at least 14 days after service of motion

Check Your Local Rules

- ☐ Many bankruptcy courts have local rules governing cash collateral and DIP financing. These rules may:
 - Require that Debtors disclose or highlight certain provisions so the court does not have to scour hundreds of pages to find important provisions
 - Require that Debtors identify provisions that the court does not generally permit except in unusual or exceptional circumstances, or provide that certain provisions are “unenforceable”
 - Require that Debtors identify provisions that the court normally allows
 - Impose additional or modified service requirements.

Hearing Day – UST’s Role

- ☐ The UST, the creditors’ committee, and the court often raise similar concerns.
- In the first days of case, the UST tries to preserve the status quo – and afford minimum relief pending formation of a creditors’ committee.
- The UST reviews the record to determine whether there is a legal and evidentiary basis for the relief requested
 - Is there evidence of immediate and irreparable injury?
 - Are the proposed payments in the budget necessary?
 - Has the Debtor demonstrated that they tried to get credit under less onerous terms but could not?

Common Requests for Relief

- ☐ Granting priority or lien on property of estate pursuant to 11 U.S.C. § 364(c) or (d)
- ☐ Providing adequate protection or priority or use of property of the estate or credit obtained to make cash payments on account of claim
- ☐ Determination regarding validity, perfection, priority, or amount of a pre-petition claim, or of any lien securing such claim
- ☐ Waiver or modification of the automatic stay
- ☐ Waiver or modification of any entity’s authority to file a plan, to seek an extension of time in which the Debtor has the exclusive right to file a plan, or the right to request the use of cash collateral or to request authority to obtain credit
- ☐ Waiver or modification of applicable nonbankruptcy law relating to the perfection of a lien on property of the estate or on the foreclosure or other enforcement of the lien

Common Requests for Relief – Cont'd

- ☐ Release, waiver, or limitation on any claim or other cause of action belonging to the estate or the trustee, including any modification of the statute of limitations or other deadline to commence an action
- ☐ Indemnification of any entity
- ☐ Release, waiver, or limitation of any right to surcharge collateral under section 506(c)
- ☐ Granting a lien on any claim or cause of action (usually avoidance actions)
- ☐ Provisions for “carve-outs” for professionals’ fees and expenses

Potentially Objectionable Terms

- ☐ Cross-collateralization clauses - clauses that secure prepetition debt with postpetition assets in which the secured party would not otherwise have a security interest based on its prepetition security agreement or applicable law
 - e.g., pre-petition agreement provides for lien only on accounts receivable, while post-petition lien proposed on accounts receivable, inventory and real estate
- ☐ “Roll-ups” - provisions deeming pre-petition debt to be post-petition debt or using post-petition loans from a pre-petition secured creditor to pay part or all of that secured creditor’s pre-petition debt
 - other than as provided in 11 U.S.C. § 552(b), which deals with security interests in proceeds and profits
- ☐ Provisions or findings of fact that bind estate or parties in interest, including committees or subsequently appointed trustees on validity, perfection or amount of the pre-petition lien or debt

Potentially Objectionable Terms- Cont'd

- ☐ Provisions or findings of fact that bind estate or parties in interest with respect to the relative priorities of the secured party's lien and liens held by persons who are not party to the stipulation
 - For example, an order approving a stipulation providing that the secured party's lien is a "first priority" lien without reference to prior permitted liens
- ☐ Waivers of, or grants of liens on, rights under 11 U.S.C. § 506(c), unless waiver or grant is effective only during period in which Debtor is authorized to use cash collateral or borrow funds.
 - could otherwise bind future trustee to preserve and care for collateral with no means to fund that duty
- ☐ Provisions that divest Debtor or trustee of discretion in formulating plan or administering estate or that limit their ability to seek relief from the court they would otherwise be entitled to seek
- ☐ Releases of, or limitations on, liability for the creditor's alleged prepetition conduct, e.g., torts or breaches of contract

Potentially Objectionable Terms- Cont'd

- ☐ Waivers of, or liens on, any of estate's rights arising under avoidance actions (11 U.S.C. §§ 544 et seq.) as well as 11 U.S.C. §§ 723(a) and 724(a) or the proceeds of any such rights
- ☐ Automatic relief from the automatic stay upon default, conversion to Chapter 7, or appointment of a trustee
- ☐ Waivers and modifications of the procedural requirements for foreclosure mandated under applicable non-bankruptcy law
- ☐ Waivers or limitations, effective on default or expiration, of right to move for authorization to use cash collateral in the absence of the secured party's consent
- ☐ Findings of fact on matters extraneous to the approval process

Potentially Objectionable Terms- Cont'd

- ☐ Provisions providing unreasonable treatment with respect to fees or professionals retained by a creditors' committee compared to any carve-outs provided for professionals retained by the Debtor in possession or trustee
- ☐ Provisions that provide an inadequate carve-out for a subsequently appointed trustee in the case, whether before or after conversion.
- ☐ Provisions that place venue in a jurisdiction other than bankruptcy court in event of a dispute
- ☐ Provisions that require Debtor to pay secured creditor's expenses or attorneys' fees without notice or review by UST, creditors' committee, if any, or court
- ☐ Provisions that seek to limit the court's supervisory powers, such as by declaring a default in the event that a trustee or examiner is appointed

The Glossary of DIP Terms

Adequate Protection: Protection given to a creditor with an interest in the Debtor's property. "Adequate Protection" often becomes an issue when a Debtor seeks to use cash collateral or other collateral, or to obtain DIP financing. The Bankruptcy Code section that governs adequate protection is section 361. Methods of providing adequate protection include:

1. Cash payments
2. Additional or replacement liens
3. Such other relief (other than an administrative expense) as will result in the realization of the "indubitable equivalent" of the creditor's interest in property

If there are no unencumbered assets or available cash, and little equity cushion in the collateral, adequate protection must usually be provided through the use of the third option: the "indubitable equivalent" of the creditor's interest. The indubitable equivalent is generally considered to be "completely compensatory" and must provide the secured creditor with its bargained-for rights. This may become an intensely litigated issue, and it often involves valuation evidence.

Administrative Expenses: Certain expenses and claims may be given "administrative" status and paid prior to unsecured claims. Typical Administrative Expenses include the actual, necessary costs of the preservation of the Estate after the Petition Date, fees of certain professionals employed by the Debtor or Committee, certain taxes, and claims for certain goods shipped to the Debtor. Administrative Expenses must be paid in full in order for a Plan of Reorganization to be Confirmed.

Automatic Stay (or the "Stay"): When a bankruptcy case is commenced, the Automatic Stay is triggered, precluding actions against the Debtor and its property.

The Glossary of DIP Terms

Avoidance Actions: Actions by the Debtor or Trustee to “avoid” certain transfers made to other parties. These often take the form of Preferences or fraudulent conveyances.

Bankruptcy Code: That portion of the United States Code containing statutory provisions governing bankruptcy.

Bankruptcy Rules: The Federal Rules of Bankruptcy Procedure.

Bar Date: The deadline for filing a Proof of Claim.

Carve-Out: A “carve-out” is an exception to the priority of certain liens, such as those of creditors with an interest in cash collateral or those of DIP Lenders, to provide for the payment of certain fees, usually those of the U.S. Trustee, Committee professionals, and the Debtor’s professionals. One often sees a carve-out in a Cash Collateral Order or a DIP Financing Order. A “cap” (or ceiling) on a carve-out is usually negotiated and set out expressly in the order. Under the guidelines of certain Courts, limits on a carve-out that call for disparate treatment of the Committee compared to the professionals retained by the Debtor, or do not include the fees of the U.S. Trustee, the reasonable expenses of the Committee members, and expenses of a Chapter 7 trustee in the event of a conversion, may be “extraordinary” and must be called to the attention of the Court.

Cash Collateral: Cash (or cash equivalents) in which the Debtor and another entity have an interest. Cash Collateral may not be used by the Debtor without consent or Court order, after notice and a hearing.

Chapter 7: The portion of the Bankruptcy Code dealing with liquidation.

Chapter 11: The portion of the Bankruptcy Code dealing with corporate reorganization.

The Glossary of DIP Terms

Committee: The Court will appoint an official committee of creditors holding unsecured claims (the “Official Committee of Unsecured Creditors”, “Creditors’ Committee” or, simply, the “Committee”). The Committee will ordinarily consist of the creditors that hold the seven largest unsecured claims, and it is designed to represent the interests of all unsecured creditors. Where appropriate, other committees, such as a committee representing the interests of equity holders, may be appointed.

Confirmation/Confirmed: The order of the Court approving a Plan of Reorganization.

Critical Vendor Motions: Motions seeking to pay what would otherwise be general unsecured claims of certain key vendors and creditors on the premise that they are “critical” to the rehabilitation or ongoing operations of the Debtor.

Debtor: A person or entity under the protection of the bankruptcy laws.

Debtor-in-Possession: A Debtor that is still operating and managing its business and has not been supplanted by a Trustee.

DIP Financing: A Debtor-in-possession may obtain post-petition financing (“debtor in possession,” or “DIP financing”) under section 364 of the Bankruptcy Code and Rule 4001 of the Bankruptcy Rules. This post-petition financing is commonly known as DIP financing.

Disclosure Statement: A document accompanying a Plan of Reorganization and used to solicit votes on the Plan; it must be pre-approved by the Court and contain enough information for a hypothetical reasonable investor to make an informed decision about whether to vote in favor of the Plan.

Estate: The Debtor’s interests in property.

The Glossary of DIP Terms

Final DIP Financing Order: A Final DIP Financing Order binds the parties and the Court to the terms of the DIP Financing on a permanent basis. A final hearing on a motion to obtain DIP financing requires fourteen days' notice of the motion.

First Days: Motions filed very early in the bankruptcy case and entertained by the Court at the first hearing. Motions for the use of cash collateral, critical vendor, utilities, prepetition wages, and interim DIP financing motions may be among the "first day" motions.

506(c): Section 506(c) of the Bankruptcy Code permits the Debtor to recover from property securing an allowed claim the reasonable and necessary costs and expenses of preserving or disposing of such property.

Interim DIP Financing Order: The Court may enter a DIP Financing Order on an interim basis shortly after the commencement of chapter 11 proceedings. An Interim Order may be issued prior to the expiration of the fourteen-day notice period required for entry of a Final DIP Financing Order, but credit may be authorized only to the extent necessary to avoid "immediate and irreparable harm" to the estate pending a final hearing. Often, only a portion of the financing is made available on an interim basis.

Liens on Avoidance Actions: The Debtor may grant liens on its claims and causes of action arising under certain sections of the Bankruptcy Code that permit it to recover certain property and/or payments made pre-petition, and the proceeds thereof, or a super-priority administrative claim payable from the proceeds of such claims or causes of action. Liens on avoidance actions may be considered extraordinary provisions in DIP Financing Orders and must be specifically disclosed in the motion seeking approval of the DIP Financing.

Petition Date: The date the bankruptcy case is commenced.

Plan of Reorganization (or the "Plan"): A document that sets forth the Debtor's plan to emerge from bankruptcy protection, including the treatment of the claims of its creditors and equity interests.

The Glossary of DIP Terms

Pre-Petition: Prior to the Petition Date.

Post-Petition: After the Petition Date.

Preferences: Actions by the Debtor or Trustee under Section 547 of the Bankruptcy Code to recover certain transfers made to or for the benefit of creditors prior to the Petition Date. The "look back" period for Preferences is 90 days before the Petition Date for non-insiders.

Prepackaged Plan: A Plan that is negotiated, made subject to disclosure and solicitation, and approved by creditors Pre-Petition.

Priming: When new liens "prime," or take priority over, existing liens. A Debtor may request authority to prime the liens of pre-petition creditors for the benefit of a post-petition lender. This is only permitted under the Bankruptcy Code upon the consent of the creditors whose liens are primed, or upon a showing that alternative financing on the proposed terms is otherwise unavailable and that the Debtor has provided the holders of existing liens that are to be "primed" with Adequate Protection of their interests.

Proof of Claim: A document asserting a claim against the Debtor or its property.

Roll-Ups: A form of DIP Financing in which the Debtor applies the proceeds of post-petition financing to satisfy, in whole or in part, pre-petition secured indebtedness. There are two basic forms:

1. **Creeping or Gradual:** A pre-petition lender provides DIP financing with the

The Glossary of DIP Terms

agreement that proceeds of collateral will be applied first to reduce the pre-petition loan until it is “rolled up” into the post-petition facility.

2. **Full:** The DIP Lender provides sufficient financing to pay off the pre-petition loan, immediately converting all of the lender’s pre-petition debt into post-petition debt.

Section 363 Sale: A sale of the Debtor’s property, usually used to refer to non-ordinary course sales.

Super-Priority Claims: The Court may provide a DIP Lender with a “super-priority claim”—a claim with priority over any and all other administrative claims, including priority claims under sections 503(b) and 507(b) of the Bankruptcy Code.