



## Debtor-in-Possession Financing: A Changing Landscape

By Cathy L. Reece

*While DIP loans continue to be a very profitable business for lenders and are attractive because they carry high interest rates and fees, certain non-monetary terms in interim DIP financing orders are being challenged by the Bankruptcy Court on a consistent basis. Lenders should be prepared to think “outside the box” if the Bankruptcy Court is not willing to grant the provisions that are requested.*

Debtor-in-Possession (DIP) financing has “reached record levels in the past two years” according to a report in the May 2003 ABF Journal. DIP loans continue to be a very profitable business for lenders and are attractive because they carry high interest rates and fees and are usually secured by a first position lien on all of the company’s assets. DIP loans by new lenders are usually approved by the Bankruptcy Courts with little resistance. On the other hand, DIP loans by pre-petition lenders are scrutinized more closely. Interest rates and fees are closely compared with applicable market rates and alternative sources of funding. The current spotlight focuses, however, on certain non-monetary terms in interim DIP financing orders which are being challenged on a consistent basis.

### **New Local Rules & General Orders**

An increasing number of Bankruptcy Courts have been adopting new local rules or general orders dealing with the procedures and the restrictions for DIP financing. For example, Local Rule 4001-2 for the Delaware Bankruptcy Court, which became effective February 1, 2001, states that the DIP financing motion must recite whether the underlying stipulation or agreement contains provisions granting cross-collateralization protection, replacement liens or other adequate protection, provisions or findings of fact concerning the validity of the perfection or amount of the lender’s pre-petition lien or debt, the waiver of the surcharge rights under Section 506(c), the granting of a security interest in avoidance actions, the use of the post petition proceeds to pay the pre-petition debt, the disparate treatment for the creditors’ committee’s

professionals and the priming of any secured lien without the consent of the lienor. The procedure requires that such provisions be highlighted and brought to the attention of the Bankruptcy Court and the parties in interest. The Local Rule states that such provisions will not be adopted in emergency interim orders except under extraordinary circumstances. Instead, such provisions will be granted only after sufficient notice at the final hearing with an opportunity for the creditors’ committee to review and object to such provisions.

A similar rule has been adopted in General Order No. M-274 by the Bankruptcy Court for the Southern District of New York on September 9, 2002, and in General Order No. 02-02 by the Bankruptcy Court for the Central District of California on April 17, 2002. Other courts around the country are reviewing similar procedures and adopting them as part of their local rules or general orders concerning first day orders. Such local rules need to be reviewed while the parties are negotiating the DIP financing so that adjustments can be made where appropriate.

### **Need For New Money**

The important question that the Bankruptcy Court will want answered right from the start is whether the company has sufficient cash flow from the collection of accounts

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receivable and proceeds of inventory sales to support the post-petition operations, or whether the company needs the advance of new cash to support its operations. The company and its professionals should prepare cash flow projections to determine and support the need for new cash. The demonstrated need for new cash is crucial to convincing a Bankruptcy Court that extraordinary circumstances exist to justify granting such provisions on an interim basis. If the continued use of cash collateral is sufficient to sustain operations in the interim, a few Bankruptcy Courts have outright denied interim DIP financing motions which contain the challenged provisions.

### **Cross-Collateralization**

The cross-collateralization aspects of DIP financing are increasingly being scrutinized. Of course, the use of all pre- and post petition assets to secure the post petition debt is routinely approved. The cross-collateralization provisions in question are the ones that allow the post petition assets and other unencumbered assets to be used to secure the pre-petition debt. It is the granting of additional collateral to shore up the lender's pre-petition debt that creates the heartburn for the Bankruptcy Court. The pre-petition lender may be able to convince the Bankruptcy Court that this protection is needed as a replacement lien for the use of the pre-petition assets, such as accounts receivable and inventory, which will decrease with collection and use. The company and the lender should have this evidence available for the emergency hearing. Linking the use of such pre-petition collateral and a replacement lien with the cross-collateralization might convince the Bankruptcy Court that this provision is justified.

### **Roll-Up**

Another provision that is carefully reviewed is the use of the post petition advances to pay off the pre-petition debt to the pre-petition lender. This is usually called a "roll-up" of the pre-petition debt into the post petition financing. A roll-up allows the pre-petition debt to be paid in full during the beginning days of the case. It converts all of the pre-petition debt to post petition debt which will need to be paid on or before the maturity date or the effective date of a Plan of Reorganization. This grants considerable leverage to the post petition lender in terms of controlling or blocking confirmation of a Plan of Reorganization. Without such payment in full of the pre-petition debt, the Bankruptcy Code under certain circumstances permits a pre-petition debt that is

secured by assets of the estate to be modified under a Plan of Reorganization even without the consent of the lender. One of the important factors that the Bankruptcy Court will look for in a roll-up is how much new money beyond payment of the pre-petition debt will be made available for the operations. When the amount of the new money is significant and the necessity for that new money is demonstrated, the Bankruptcy Court is more inclined to approve the roll-up. Sometimes the advantage of the post petition financing and the mechanism for administering the post petition financing can also be sufficient to justify the roll-up. The extent to which the pre-petition and post petition collateral can be segregated could be an important factor. The Bankruptcy Court will also look at whether the roll-up can be unwound and whether there is a review period for the creditors' committee to investigate the benefits and costs to the estate of the roll-up.

### **Waiver, Release & Acknowledgment of Validity**

Another term which is scrutinized in the interim DIP financing motion is the waiver or release of pre-petition claims against the lender and the findings of fact as to the validity of the pre-petition debt and security interest. The lender customarily wants to have releases, waivers and acknowledgment of the validity of the debt and security interest. The Bankruptcy Court's inquiry is usually whether such provisions are intended to be binding upon a future Chapter 11 or 7 trustee and other creditors in the estate, particularly a subsequently appointed creditors' committee. The company may know in the early days of the case of the existence and merit of defenses, if any, to the validity of the debt or security interest and may be familiar with the causes of action that could be maintained against the lender, but it is rare that any other parties are aware of such matters. The Bankruptcy Court is reluctant to allow potential causes of action and defenses to be waived and released without some reasonable opportunity for the creditors' committee to be able to review such matters. The review time period for creditors' committees is usually negotiated and varies from 30 days to 90 days depending on the complexities of the issues that could arise and how fast a committee can be formed. Usually, the lender can still obtain a waiver and release from the company and an acknowledgment of the validity of the debt and security interest by the company in the interim DIP financing order, thus reducing the number of parties that are likely to take aim at the lender.

### **Waiver of Surcharge**

The waiver by the company of a right to surcharge the lender's collateral under Section 506(c) is another provision under attack. Often the Bankruptcy Court will allow the waiver of the surcharge by the company as to the post petition lender where the parties have fully negotiated a budget and cash flow projections which reflect that there will be sufficient operating cash to pay the post petition rent, utilities, payroll, taxes, trade payables, insurance and other necessary operational expenses. The lender, by allowing the loan proceeds to be used to pay regular day to day operational expenses, can help the company avoid surprises that could result in a surcharge and can help alleviate the concerns of the Bankruptcy Court in waiving this important right by the company.

### **Carve-Out**

Another provision closely reviewed by the Bankruptcy Court deals with the availability of funds to pay both the company's and the creditors' committee's professionals. This is often referred to as the "carve-out" provision. The company's counsel is usually very successful in negotiating a carve-out for its own fees so that it can be assured that it will be paid through the available cash. The question is whether the creditors' committee's professionals are going to be treated differently from the company's professionals. The Bankruptcy Court is reluctant to allow the company's professionals to be paid and not the committee's professionals and therefore requires that the professionals be treated equally with no disparate treatment between the two. In addition, the Bankruptcy Court may focus on the services to be incurred by the committee that will be excluded from the carve-out. Typically, the fees incurred by the committee's professionals in reviewing the validity of the pre-petition debt and security interest and the nature of the claims and releases to be given as a part of the DIP financing will be agreeable to the lender, whereas the fees for the prosecution of any claims and causes of action against the pre-petition lender will not be approved by the pre-petition lender. The Bankruptcy Court understands the difference and usually accepts this as a reasonable compromise.

### **Term, Default, and Remedies**

The term of the DIP financing, the default notice, the cure period and the remedies are also reviewed by the Bankruptcy Court. A term needs to be long enough to be meaningful for the rights that are being given up and sufficient in length

to be able to provide some stability to the operations and the life of the case. Sometimes DIP financing for 60 days or 90 days is not sufficient for the justification of releasing claims or providing cross-collateralization or a roll-up of a pre-petition debt whereas a one-year term and a sufficient amount of additional new cash would outweigh and justify the cross-collateralization, roll-up, and release. The Bankruptcy Court also may require sufficient notice to be given to the company and the creditors' committee of a default to allow them sufficient time to come into Court to protect the estate. Commonly, the consent to use of cash collateral and other pre-petition assets and the obligation to advance new money will cease upon an event of default. The length of the cure period or notice period is negotiated between the parties. Two to five business days are not uncommon compromises. The remedies are also negotiable and, in some situations, the Bankruptcy Court may have approved the lifting of the stay in advance to allow the remedies to go forward after a notice and cure period but reserving an opportunity for the company and the creditors' committee to come into Bankruptcy Court to seek a stay. In other situations, the burden is placed upon the lender to seek relief from the stay. It is the threat of shutting down the business that will necessitate quick action by either side and the intervention of the Bankruptcy Court.

### Some Practical Advice

As a practical matter, one of the important things that both the lender and the company can do while they are negotiating and discussing the DIP financing is to identify whether the use of the cash collateral as projected is sufficient or whether new financing is necessary. The parties can then negotiate the DIP financing order and the appropriate provisions to support such choice.

The monetary and non-monetary terms of the DIP financing order should be discussed in light of the Local Rules and the experience and precedent set by the judge in similar cases.

Once the terms and the provisions have been agreed upon by the company and the lender, the U.S. Trustee should be brought into the process as early as possible, even prior to the filing of the bankruptcy, if possible, for discussion and review of the interim DIP financing order. The Bankruptcy Court is increasingly sensitive to the due process arguments that are raised by both the U.S. Trustee and the creditors' committee when upon no more than one or two hours notice the company requests the Bankruptcy Court to enter a DIP financing order with all of the highlighted provisions. The Bankruptcy Court's predictable reaction is to slow down the process to provide sufficient due process and notice to both the U.S. Trustee and the twenty largest creditors so that the analysis on an interim basis can be meaningful. If possible the company and lender should plan ahead so that there is sufficient cash available in the system to get the company through a few days so that the company can volunteer and suggest the amount of notice that can be given for the emergency interim motion.

Demonstrate the business need for the cross-collateralization or the roll-up. There may be administrative reasons why a roll-up needs to be done or why cross-collateralization is important in light of the nature of the collateral. Don't wait for the Bankruptcy Court to ask. Be prepared and take the initiative.

Be prepared to think outside the box if the Bankruptcy Court is not willing to grant the provisions that are requested. For example, if roll-up is not granted, then find another way to determine how to advance under an asset-based lending formula to still provide sufficient cash to the company to keep it in business. It may

require that the pre-petition debt be paid down with the pre-petition receivable collections while the post petition debt is advanced out of formula pursuant to a budget until sufficient post petition receivables are created. There may need to be some creative thinking with regards to the formula or the amounts to be budgeted to allow the company to have sufficient cash. Some lenders are not prepared to deal with such complications, but judges are increasingly putting lenders in that box.

It is the nature of the interim relief requested which troubles the Bankruptcy Court. Sometimes it is better for the lender to not request such provisions in the interim DIP financing order but make it clear up front that certain provisions will be requested for the final DIP financing order once sufficient notice and an opportunity to review those provisions has been given to the creditors' committee. [abfj](#)

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