# DIP Financing: Why Rational Actors Lend to Bankrupt Businesses

**By Matt Eisenberg and Erik Lawrence**

As economic conditions continue to deteriorate, some local businesses will have no other choice than to file for bankruptcy protection. In many cases, such businesses will file for a Chapter 11 reorganization rather than a Chapter 7 liquidation.

In a Chapter 11 reorganization, the struggling business proposes a plan of reorganization to keep it alive and (at least partially) pay creditors over time.[1] During the reorganization, the business will require operating capital to fund operations. This begs the question, if a company is bankrupt, and therefore out of cash, where can it obtain operating capital? The answer is a type of financing called debtor in possession or "DIP" financing. Creditors that provide DIP financing aren't irrational actors; the U.S. Bankruptcy Code contains substantial protections for such creditors. This article describes those protections and how DIP financing arrangements are typically structured.

## Chapter 11 Basics

To understand DIP financing, it will help to have some basic background on Chapter 11 reorganizations. In most Chapter 11 cases, the company, called a "debtor in possession," keeps possession and control of its assets, operates the business and performs many of the functions that a bankruptcy trustee ordinarily performs.[2] In typical Chapter 11 reorganizations, secured creditors have the first priority of repayment. The remaining creditors are repaid in the order that the Bankruptcy Court determines in accordance with the Bankruptcy Code. Certain expenses incurred during the reorganization process, so-called "administrative expenses," will be paid ahead of general unsecured claims but after secured claims.[3]

Immediately upon the bankruptcy filing, and until the case is closed or dismissed, the debtor in possession will enjoy the protection of an "automatic stay."[4] By virtue of the automatic stay, all judgments, collection activities, enforcement activities, foreclosures and repossessions of property are suspended and may not be pursued by the company's creditors (with certain exceptions).[5] A lien granted under a security agreement before a business files for Chapter 11 protection (for example, a lien against inventory) will not extend to like property that the business acquires after the bankruptcy case begins. Creditors existing before the Chapter 11 case begins are referred to as "pre-petition" creditors.[6]

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[1] *See generally* 11 U.S.C. §§1121-29.
[2] *See* 11 U.S.C. §§1101, 1107.
[3] *See* 11 U.S.C. §§503(b), 507(a)(2) and 726(b).
[4] *See* 11 U.S.C. §362.
[5] *Id*.
[6] *See*11 U.S.C. §552(a).

DIP Financing Arrangements.

Bankruptcy Court approval is pursued for DIP financing because the Bankruptcy Court can generally avoid such financing arrangements if they are entered into without such prior approval.[7] Either a pre-petition creditor or a new one can provide DIP financing.

*DIP Financing From A Pre-Petition Creditor*. A pre-petition secured creditor that wishes to provide DIP financing may obtain a lien against collateral (real or personal property) acquired by the debtor in possession after the case begins (so-called "cross-collateralization").[8] Generally, a Bankruptcy Court will only approve cross-collateralization if a pre-petition creditor makes a significant commitment to provide post-petition credit. If a pre-petition creditor were to seek cross-collateralization merely to strengthen a pre-petition claim, a Bankruptcy Court will generally not approve it. Alternatively, a pre-petition secured creditor may seek to provide a "roll-up" facility. In such a facility, the debtor in possession agrees to use cash generated post-petition to repay the creditor's pre-petition debt, and the creditor/lender agrees to extend additional credit to the debtor in possession secured by assets acquired post-petition. Over time, a roll-up facility converts pre-petition secured debt to a true DIP financing facility.

*DIP Financing From A New Creditor*. A variety of entities, including traditional lenders, may provide new credit to a debtor in possession. Generally speaking, the Bankruptcy Code provides five levels of protection for such lenders, which it can issue separately or in some combination, depending on the circumstances: (1) administrative expense claim; (2) "super-priority" administrative expense claim; (3) junior lien on an encumbered asset; (4) senior lien on unencumbered asset; or (5) "priming" lien.

Administrative Expense Claim. A post-petition creditor may provide unsecured credit in the ordinary course of business (such as trade credit) without the Bankruptcy Court's approval.[9] A post-petition creditor may also provide an unsecured loan outside of the ordinary course of business after notice and a hearing.[10] In either case, such a loan will be accorded simple administrative expense priority.

"Super-Priority" Administrative Expense Claim. If the debtor in possession can demonstrate to the Bankruptcy Court that post-petition financing is not otherwise available, it may obtain unsecured credit that is accorded administrative expense priority that is superior to all other administrative expense claims (a so-called "super-priority" administrative expense claim).[11] To demonstrate that financing is not otherwise

[7] *See* 11 U.S.C. §549(a).
[8] *See* Burchinal v. Cent. Wash. Bank (In re Adams Apple, Inc.), 829 F.2d 1484, 1490-91 (9th Cir. 1987); *but see* Shapiro v. Saybrook Mfg. Co., Inc. (In re Saybrook Mfg. Co., Inc.), 963 F.2d 1490, 1494-95 (11th Cir. 1991).
[9] *See* 11 U.S.C. §364(a).
[10] *See* 11 U.S.C. §364(b).
[11] *See* 11 U.S.C. §364(c)(1).

available, the debtor in possession must demonstrate an inability to obtain credit from financial institutions in the immediate geographical area on more lenient terms.[12] A debtor in possession seeking to provide a junior, senior or priming lien (discussed below) must also demonstrate this. Post-petition lenders generally seek greater protection than a super-priority administrative expense claim alone.

Junior Lien on an Encumbered Asset. A debtor in possession may seek to obtain credit that is secured by a junior lien against encumbered assets.[13] Post-petition lenders are generally reluctant to provide DIP financing that is secured only by a junior lien however.

Senior Lien on Unencumbered Assets. A debtor in possession may seek to obtain credit that is secured by a senior lien against unencumbered assets.[14] A typical debtor in possession has few unencumbered assets and thus lenders rarely seek this level of protection either.

"Priming" Lien. The most sought-after level of protection is a lien that is equal or senior to an existing lien (a so-called "priming" lien).[15] To provide a priming lien, the debtor in possession must prove that the existing lienholder(s) will be "adequately protected" after a priming lien is granted. A Bankruptcy Court will typically hold that an existing lienholder is adequately protected if the debtor in possession: (1) provides the existing lienholder with a cash payment that makes up for the decrease in that creditor's security interest;[16] (2) provides the existing lienholder with a replacement lien that makes up for the decrease in that lienholder's security interest;[17] or (3) proves that the existing lienholder will realize the equivalent value of its existing lien after the priming lien is granted – typically this is done by demonstrating that the underlying asset's value minus the priming lien is sufficient to cover the existing lienholder's claim (a so-called "equity cushion").[18] Post-petition creditors generally will only provide DIP financing if it is secured by a priming lien. As the value of various real and personal property assets plummet due to the current economic crisis, the "adequate protection" standards are likely to loosen up somewhat to allow for the protections provided by the priming lien.

*Other Negotiated Provisions in a DIP Financing Agreement*. A post-petition DIP lender will generally require both that the facility be secured by a priming lien and that all amounts owed under the DIP facility constitute a super-priority administrative expense claim. Such a lender will often seek automatic relief from the stay as well to pursue its rights, including liquidation of collateral or foreclosure upon default by the debtor. In addition to typical events of default, DIP financing loan agreements should contain the following unique events of default so that the DIP lender can enforce its rights ("call" the

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[12] *See* Bray v. Shenandoah Fed. Sav. & Loan Ass'n (In re Snowshoe Co., Inc.), 780 F.2d 1085, 1088 (4th Cir. 1986); In re Plabell Rubber Prods., Inc., 137 B.R. 897, 899 (Bankr. N.D. Ohio 1992).
[13] *See* 11 U.S.C. §364(c)(3).
[14] *See* 11 U.S.C. §364(c)(2).
[15] *See* 11 U.S.C. §364(d).
[16] *See* 11 U.S.C. §361(1).
[17] *See* 11 U.S.C. §361(2).
[18] *See* 11 U.S.C. §361(3); In re Gallegos Research Group Corp., 193 B.R. 577, 585 (Bankr. D. Colo. 1995).

loan, foreclose on assets, etc.) if any of the following occur: (1) the Chapter 11 Case is dismissed or converted to a Chapter 7; (2) the Bankruptcy Court appoints a trustee or an examiner with expanded powers; (3) the debtor in possession incurs any additional post-petition debt outside the ordinary course of business; (4) the Bankruptcy Court modifies the order in which it originally authorized the DIP financing facility; (5) the Bankruptcy Court grants relief from stay to any holder of a junior lien in the collateral that secures the DIP facility; and (6) any post-petition judgments are entered against the debtor in possession.

Conclusion.

Although we all attempt to banish the thought from our minds, we know that the number of companies seeking Chapter 11 bankruptcy protection will surely increase in the coming months and year as the recession finds its bottom. Creditors that are willing to navigate the recesses of the Bankruptcy Code may find that providing DIP financing on protected terms is a worthwhile and profitable endeavor in these uncertain times.

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