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Obtaining DIP Financing and Using Cash Collateral

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Editor's Note: *Cash is the lifeblood of any business enterprise. Few companies enjoy a cash flow that is constant; most must periodically resort to borrowings to meet everyday cash-consumption needs. This is particularly true of chapter 11 debtors because most companies experience a constriction of credit in the weeks and months leading up to a bankruptcy filing and, at the same time, face additional expenses and/or loss of revenue that tend to exacerbate matters as they enter bankruptcy. On top of all this, a company under bankruptcy protection must comply with certain legal requirements before it can borrow money and, in many cases, before it can even use its cash. This month, in the 13th of their series, the authors explain the basics of post-petition financing and use of cash collateral.*

For the outsider, one of the oddest things about chapter 11 is that one can make money by lending money to a debtor in bankruptcy. But it's a fact. The Bankruptcy Code's framework for so-called "debtor-in-possession (DIP) financing," a.k.a. "post-petition lending," is one of the most important (and revolutionary) innovations introduced in the 1978 Code. Indeed, an entire industry has grown up around the rules authorizing post-petition finance, and a good many chapter 11 cases would be impossible without it. And—noteworthy for our purposes here—a good many professionals in our field spend a good portion of their professional lives conceiving, negotiating, papering (or challenging) these post-petition financing arrangements.

The centerpiece of the post-petition lending apparatus is Code §364, which sets forth a scheme of escalating priorities for post-petition financing. We begin this installment by outlining §364. Then we turn our attention to the rules governing "use of cash collateral." We include discussion of cash-collateral usage because even a company whose operations produce cash sufficient to enable it to self-fund cannot use its cash without complying with these rules if the cash generated constitutes the cash collateral of another entity. Moreover, as you will see below, there is a high level of interrelatedness between the two topics.

Basic Substantive Framework Governing DIP Financing

Section 364 authorizes "the trustee" (read: DIP) to "obtain credit." More to the point, it outlines four paths whereby a lender may achieve priority for money advanced to a debtor after the petition date. They are:

- If the DIP borrows "in the ordinary course of business," then the lender's claim is a first-priority administrative expense under §364(a). This priority is perhaps best understood as a protection for post-petition trade vendors.
- Even outside the ordinary course of business, the creditor may get an administrative priority if the post-petition advance and the administrative priority are approved by a court order. This is §364(b). But as a practical matter, it doesn't happen very often because most creditors who want to do post-petition lending try to squeeze themselves in under subsections (c) and (d).
- If the DIP can't get unsecured credit, the court may authorize the lender to get a "super-priority" administrative claim, or the court may authorize the lender to take a security interest in unencumbered property (or a subordinate security interest in encumbered property). This is §364(c). The Code seems to suggest that a lender may obtain *either* a super-priority administrative expense *or* a post-petition lien, but not both. However, we have seen many situations in which both of these protections were granted to a DIP lender.
- Finally, if the DIP cannot get credit otherwise, the court may authorize a security interest that is "senior or equal" to an existing security interest. A DIP loan with a lien that is senior in priority to existing pre-petition liens is sometimes referred to as a "priming lien." It is the most extraordinary protection for a post-petition lender. It requires showing that the lender whose lien is "primed" is adequately protected. Priming liens are not often approved over the objection of the pre-petition secured lender, but it does happen sometimes. In addition, the pre-petition lender will often agree to the priming lien in order to induce a new lender to advance money post-petition.

In order to obtain approval of one of these escalating priorities, the DIP (or trustee) must show the court that financing was not available with one of the lower priorities. At the hearing, the DIP (or trustee) should be prepared to discuss its efforts to obtain financing on less onerous terms.

Framework Governing the Use of Cash Collateral

You learned in earlier installments that in chapter 11, the DIP can continue to operate its business without a court order until the judge orders otherwise. But lawfulness is only one issue; practicalities are another. The ordinary debtor won't make it to lunchtime without some operating income. And, as explained above, this is why a debtor that is strapped for cash must be able to borrow money. But what if the debtor's operations produce sufficient cash so that it does not need to borrow money? Well, even if it does have the cash, the chances are that all of it

was pledged, pre-petition, to secured creditor(s).

Security agreements typically give the secured creditor a first-priority security interest in all of the debtor's (a) inventory, (b) accounts receivable and (c) proceeds of inventory or accounts receivable. In the ordinary course, this works fine: Inventory becomes accounts, which becomes cash, which becomes new inventory and so forth. But now in chapter 11, it means the creditor has its hands on the debtor's throat: The debtor can't do anything without cash, and he can't touch the encumbered cash or cash equivalents (cash collateral) without the permission of the secured creditor or a court order.

Bankruptcy Code §363(c) provides that the DIP may use "cash collateral" only with (a) creditor consent or (b) a court order. In a contested hearing, the pre-petition lender has the burden to prove the "validity, priority or extent" of its interest in cash collateral. The debtor has the burden of proving that the pre-petition lender is "adequately protected." Bankruptcy Code §363(o) lays out these rules. Adequate protection is defined in Bankruptcy Code §361.

Negotiated cash-collateral orders are fairly common. This is predictable for several reasons. First, use of cash is essential to preserve going-concern value. Thus, there is typically a strong unity of interest on this matter between a debtor and its pre-petition lender, even where there are other disagreements. Second, courts tend to understand the need, and so are inclined to allow cash collateral use. Finally, a lender can enhance its position by negotiating certain terms into an "agreed" cash-collateral order.

This last point requires amplification: A pre-petition lender is also often the DIP lender in a chapter 11 case. Thus, a single motion often combines a request to use cash collateral with a request to incur DIP financing. A common tactic of such pre-petition lenders/DIP financiers is to characterize a contemplated DIP financing that includes permission to use cash collateral as purely a DIP financing. However, bankruptcy courts understand that different rights ought to inure to a lender who makes a truly new advance of funds as opposed to a lender who is merely permitting the use of cash collateral (more on this below).

Procedural Overview (of DIP Financing and Cash-collateral Motions)

Requests for approval of cash-collateral usage and DIP loans often come to the court on a very expedited basis—within the first few days of the case. In the extreme (but not unusual) case, the debtor and the secured creditor show up in court on an emergency motion, filed moments after the case was filed, seeking an instant authorization for a post-petition line of credit. The request arrives accompanied by an annex about the size of the Topeka (Kan.) phonebook, outlining the terms and conditions to which the DIP and the creditor agreed. In addition (the secured creditor and DIP repeat in unison), the judge needs to sign the order *now,* so the business can continue to operate.

Judges (not to mention U.S. Trustees) are often concerned that (1) they don't have sufficient time to review and develop an understanding of what they are being asked to approve; (2) creditors don't have an opportunity to review the arrangement, even though it can have a substantial impact on the rest of the case; and (3) no creditors' committee is in place. Courts struggle to balance the legitimate interests of the parties with these concerns.

Bankruptcy Rule 4001 addresses these concerns. First, it provides for an interim hearing at the beginning of the case, followed by a full-blown hearing at least 15 days' notice later. At the interim hearing, the court may authorize DIP financing and/or cash collateral use only to the extent necessary to avoid irreparable damage pending the final hearing. Some courts impose additional requirements that have the effect of causing a further delay before a final hearing can take place. For example, some courts will not conduct a final hearing on DIP financing before a committee is appointed and has had the opportunity to engage counsel.

Even within the framework of Rule 4001, courts have expressed a good deal of anxiety over the content of DIP financing and cash-collateral orders. One remarkable emblem of this concern is an open letter that Bankruptcy Judge **Peter J. Walsh** wrote to the Delaware Bar. In his letter (dated April 2, 1998), Judge Walsh itemized a number of provisions that, he said, parties should ordinarily avoid seeking in interim DIP and cash-collateral motions. These include:

- provisions that are "just too verbose and cover unnecessary matters;"
- provisions that incorporate specific sections of underlying loan documents without a statement of the sections' import;
- provisions that state the court has examined all of the underlying loan documents or that it approves of their terms;
- lengthy recitations of fact concerning the relationship between the debtor and the lender (and suggesting instead the use of stipulations);
- statements that parties in interest have been afforded "sufficient and adequate notice" (and suggesting that the order recite instead that the hearing is being held pursuant to Bankruptcy Rule 4001(c)(2) and listing the parties to whom notice was given);
- provisions that grant the lender a lien on avoidance actions;
- any attempt to limit the committee's right to challenge a lender's pre-petition position to less than 60 days (and in most cases to less than 90 days) or to not grant committee counsel a carveout; and
- provisions that expressly or by their terms have the effect of divesting a debtor of any discretion in formulating a plan.

We recommend that you read Judge Walsh's letter.[1] Other courts have local rules or other written guidance along the same lines. One common requirement is that specific provisions (such as cross collateralization, §506(c) waivers, lien on avoidance actions and the like) be identified in a motion, so the judge does not inadvertently miss seeing them.

Bedrock Planning Steps

The first steps in thinking about cash-collateral and/or DIP-financing issues should involve thorough due diligence of existing loan documents. Not surprisingly, a pre-petition lender's attitude in negotiations can change dramatically when it learns that it did not properly perfect or has some other problem of which it was previously unaware.

The development of a budget of cash expenditures is also essential. First, as described above, the court has to be able to review it to make sure that it approves only that which is essential at the initial hearing stage. Just as importantly, lenders demand it because they want to make sure that cash is being spent in a way they think makes sense (*i.e.,* in a way that will maximize the likelihood of their getting repaid). Liquidation valuations are also likely to be demanded by pre- and post-petition lenders alike: Pre-petition lenders need them to weigh the desirability of a liquidation against a reorganization; post-petition lenders need them to assess the collateral base of their loans. ■

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[1] Feel free to e-mail Jonathan Friedland if you would like a copy of the Walsh letter.

[1] For a general discussion of recharacterization and some of the other pitfalls related to providing additional capital infusions to troubled companies, *see* Sprayregen, James H.M., and Friedland, Jonathan P.,