Debtor-in-Possession
Financing

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Can you imagine the reaction the first time a lender said, “Hey, let’s lend large sums of money to a bankrupt company!”? As it turns out, lending to a debtor in possession can be a smart move. This article explains, in general terms, the hows and whys of DIP lending.

It may seem counterintuitive that banks and other institutions would compete fiercely to provide loans to companies that have recently filed for protection under Chapter 11 of the U.S. Bankruptcy Code. But they do—and often. Indeed, “DIP loans,” as they often are called, are big business and can range from tens of thousands to billions of dollars. Moreover, lending institutions of all sizes may be called on to extend further credit to a bankruptcy debtor to “protect” an existing loan position.

Companies that enter into Chapter 11 reorganization continue to be run by their existing management in virtually all cases. The ongoing entity is known as the debtor in possession, or DIP. In Chapter 11, pre-bankruptcy creditors are, for the most part, stayed from enforcement remedies and do not receive payment of principal or interest while the company seeks to rationalize its business and formulate a plan of reorganization to restructure its balance sheet.

The DIP typically finds itself in need of credit immediately after initiating a Chapter 11 case. While most of its pre-bankruptcy liabilities are frozen, the company is likely to need cash immediately to cover payroll and the up-front costs of stabilizing the business. Although post-bankruptcy credit extended by vendors is granted administrative expense priority over all pre-bankruptcy unsecured claims, vendors typically place Chapter 11 debtors on C.O.D. or C.B.D. until the company stabilizes and working capital financing for the company’s ongoing operations is available.

DIP loans are typically asset-based, revolving working-capital facilities put into place at the outset of Chapter 11 to provide both immediate cash as well as ongoing working capital during the reorganization process. Perhaps most important, DIP financing helps the company restore vendor and customer confidence in the company’s ability to maintain its liquidity.

Protections for DIP Lenders

Congress understood that lenders might well be skittish about extending credit to a com-
pany that has filed for bankruptcy, so the bankruptcy court extends to DIP lenders a number of powerful protections. If the debtor can demonstrate that financing could not be procured on any other basis, the court can, subject to certain limitations, authorize the debtor to grant the DIP lender a lien that has priority over pre-bankruptcy secured creditors (priming lien) and a claim with super-priority over administrative expenses (including vendor and employee claims) incurred during Chapter 11 and over all other claims.

The DIP lender typically will insist on a first-priority priming lien on the debtor’s inventory, receivables, and cash (whether or not previously encumbered), a second lien on any other encumbered property, and a first-priority lien on all of the debtor’s unencumbered property.

A priming lien can be granted only with the consent of the secured creditors who are being primed or if the court finds that the creditors are adequately protected despite the granting of the priming DIP lien. In many cases, pre-bankruptcy inventory and receivables lenders consent to being primed and to the use of their cash collateral in exchange for a package of protections specified in the court order approving the financing (DIP Order). These protections typically include a second lien on unencumbered assets (behind the DIP loan) and, quite often, current cash payment of interest. One reason secured lenders often consent to being primed is because the value of their collateral interest (and thus their recovery) will plummet unless new money is lent to the debtor to maintain operations and inspire vendor and customer confidence.

In common bankruptcy parlance, a DIP loan provided by the existing secured lenders is referred to as a defensive DIP while a loan from a new third party lender is called an offensive or new money DIP.

Creditors secured by isolated assets often do not consent to being primed, and, assuming the DIP lender is satisfied with its other collateral, the DIP lender often does not seek to prime existing lenders with respect to these assets.

In addition to collateral and a super-priority claim, DIP loans are typically designed with covenants and other protections to permit the DIP lender a full recovery even if the debtor liquidates. The loan documents and/or the DIP Order, for example, will typically provide:

1. For a borrowing base.
2. That all asset-sale proceeds must be applied to reduce the DIP loans and commitments.
3. That the primed pre-bankruptcy lenders cannot exercise remedies until the DIP has been repaid.
4. That certain events, like conversion of the case to Chapter 7 or appointment of a trustee in bankruptcy, permit the DIP lender to call the loan.

**DIP Loan Negotiation and Pricing**

In larger cases, DIP loans typically are negotiated over a one- or two-week period just prior to the commencement of Chapter 11 proceedings. The lender arranging the DIP loan typically first enters into an engagement letter providing for an advance against expenses and then sends internal or external experts to conduct an expedited review of the working-capital collateral and the debtor’s post-Chapter-11 cash flow projections. Once the lender satisfies itself regarding the collateral and the DIP financing has been “sized” based on the debtor’s expected needs, the parties proceed to a commitment letter and final documentation.

In some cases, where there is time pressure, the commitment-letter stage is bypassed.

DIP loans are often sized to be somewhat—or far—larger than the expected needs of the debtor because announcing a large facility may inspire vendor and customer confidence and actually reduce the
need for use of the facility. Sometimes the DIP lender, through various mechanisms, will limit use of some part of the facility so the lender is comfortable it will be protected if the debtor seeks to exceed the forecasted usage. Besides the important borrower benefits, a larger facility benefits the DIP lender because commitment and facility fees apply to the full facility, whether or not the debtor ever uses it all.

Pricing on DIP loans has historically been relatively high for first-lien working-capital financing, but the DIP lending business has become more competitive during the past 10 years and pressure on pricing has increased. Lately, hedge funds and other new entrants in the DIP lending market have further increased competition. Pricing will often include a fee paid at the time of the initial commitment letter, further fees paid at the time the loan is closed, ongoing commitment fees, and, of course, interest on the loans themselves. The pricing can be affected by a number of factors, such as whether the facility is a defensive DIP (where pricing will tend to be somewhat lower) and whether the DIP lender is the only available source of funds (where pricing will likely be somewhat higher).

Syndication of larger DIP facilities often waits until after Chapter 11 proceedings begin. Sometimes the lead arranger underwrites the entire facility; other times a small group of initial participants is included. The early entrants are, of course, able to obtain a larger share of the upfront fees, inducing lenders to become part of the underwriting group.

**DIP Loan Approval Process**

Approval of priming liens and super-priority claims in connection with a DIP loan requires “notice and hearing” under the Bankruptcy Code, and it is the debtor’s burden to demonstrate that lenders who are being primed are being “adequately protected.” However, because the debtor typically needs to draw on the facility at the outset of the Chapter 11 proceeding and because it is desirable to obtain early approval of the DIP financing to restore vendor confidence, DIP loans are typically approved in a two-step process during the first month of the Chapter 11 case.

1. In the first step, an interim DIP hearing is held within a couple of days after the Chapter 11 petition is filed, on notice to 1) the lenders who are being primed, 2) the 20-50 largest unsecured creditors of the debtor (depending on the size of the case), and 3) the office of the U.S. Trustee (a division of the U.S. Department of Justice that is designated in the Bankruptcy Code to perform a number of functions in bankruptcy cases). At the interim DIP hearing, the debtor seeks approval to use only that portion of the DIP commitments it will need until a final DIP hearing can be held.

2. The final DIP hearing will generally be scheduled within 30 to 45 days after the official committee representing the interests of unsecured creditors (the Creditors Committee) is appointed.

If objections are made at the interim DIP hearing, they usually come from the U.S. Trustee. While the timing and amount of fees paid to the DIP lender are sometimes an issue, more typically the U.S. Trustee raises issues relating to the adequate protection package being offered to the pre-bankruptcy lenders being primed by the DIP. Occasionally, there will be a dispute over whether the terms of the proposed DIP are the best available. Assuming the judge is satisfied, an interim DIP Order is entered, and the loan documents are signed promptly to make a portion of the DIP facility available to the debtor. The interim DIP Order will specify the date of the final DIP hearing.

The balance of the commitments under the DIP facility will be approved at the final DIP hearing, after the Creditors Committee has had time to review the deal. Syndication of the DIP loan, if the arranger decides to do so, typically is completed by the time of the final hearing.

On occasion, the Creditors Committee will object to some terms of the deal or the adequate protection package, and the Committee’s objections will have to be resolved by negotiation or overruled by the court. In many cases, the Creditors Committee recognizes the need for the DIP facility, and any objections it has are resolved before the final hearing. At the hearing, the court will then enter the final DIP Order.
If a DIP Order Is Overturned on Appeal

Orders approving DIP financings are rarely appealed. However, given the litigation overlay of a bankruptcy proceeding, a prospective DIP lender may legitimately ask what happens in the unlikely event an appeal is taken and the DIP Order is reversed.

Anticipating concerns among lenders on this score, Congress included a provision in the Bankruptcy Code stating that reversal or modification of the DIP Order (including the granting of priority and liens) “does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended credit in good faith” unless the effect of the DIP Order was stayed pending appeal. Most DIP Orders therefore contain an express good-faith finding.

Perfecting a DIP Lender’s Lien

Because the Bankruptcy Court has jurisdiction over the debtor’s property, DIP Orders usually contain a provision stating that the DIP liens are perfected without further action under state law. However, while the order is occasionally relied on without further lien filings, in most cases DIP lenders take the further steps of signing customary collateral documentation and completing necessary filings. Often this is accomplished in due course after closing, and the DIP Order typically contains “further assurances” language requiring the debtor to complete this documentation. One of the reasons DIP lenders typically decline to rely solely on the DIP Order is the possible need to enforce their liens in a forum other than the Bankruptcy Court. If this becomes necessary, it is helpful to have already completed the necessary state law filings.

Conclusion

Lending to a company in Chapter 11 is complex from a variety of perspectives, and this article does not address the numerous technical aspects of debtor-in-possession financing. As with any other extension of credit, each DIP lending opportunity should be carefully evaluated from a business and legal perspective. Particular attention should be focused on the quality of the liquid collateral, the credibility of debtor’s projections, the rights of third-party creditors, and the attitudes of the U.S. Trustee’s office and the court where the bankruptcy case is pending. That said, in many cases, it can be an eminently logical and profitable endeavor. Indeed, because of the many lender protections enshrined in the U.S. Bankruptcy Code to induce DIP lending, the safest loans in a troubled industry may well be those made to bankruptcy debtors.

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