An Overview of Debtor in Possession Financing

Fried, Frank, Harris, Shriver & Jacobson LLP
Gary L. Kaplan
Julian S.H. Chung

Introduction

When companies with existing credit facilities are in financial distress, whether as a result of adverse market forces, covenant or other defaults under their debt facilities or unexpected business interruption, they may lose access to liquidity under their existing credit facilities or face the potential exercise of remedies by lenders under their existing credit facilities. In such circumstances, since a leveraged company’s assets are typically pledged to secure its existing indebtedness, it is nearly impossible to attract new capital to continue operations or to refinance existing debt. A chapter 11 bankruptcy can provide such a distressed company with an opportunity to obtain financing in the form of debtor in possession financing (“DIP Financing”).

DIP Financing provides a lifeline to companies that would otherwise run out of cash and have no ability to satisfy near-term obligations, including debt service, payroll, rent and other operating expenses. Lenders may be willing to provide DIP Financing to otherwise non-credit-worthy companies because they receive lender protections that are not available outside of a chapter 11 process, including the ability to prime existing liens, court approval of the financing terms to avoid future challenges by other creditors and strict controls on how the borrower spends the funds.

While the benefits to the debtor are obvious, creditors and lenders have strategic incentives to provide or consent to the DIP Financing. As a simple economic matter, DIP financings typically have higher interest rates and fees than lenders can obtain outside of chapter 11 for similar loans, and are a relatively safe investment due to the protections afforded by the Bankruptcy Code and the Bankruptcy Court. As a result, DIP Financing is a relatively high yielding investment.

In addition, the debtor’s existing pre-bankruptcy lenders frequently use the various mechanisms available to DIP lenders to help protect their existing investment in the debtor and, in some cases, make a play for ownership of the reorganised entity post-emergence through the DIP Financing. An understanding of the basics of DIP Financing and how the various and often conflicting interests of the debtor, its DIP lenders, and creditors are addressed within a chapter 11 case provides a crucial insight into one of the driving forces of the reorganisation process.

DIP Financing Under the Bankruptcy Code

DIP Financing, like other aspects of chapter 11 bankruptcy, is governed by chapter 11 of Title 11 of the United States Code (the “Bankruptcy Code”). Specifically, section 364 of the Bankruptcy Code authorises DIP Financing arrangements by allowing the “debtor” to obtain post-petition (i.e., post-bankruptcy filing) credit. It also incentivises both new and existing lenders to make loans by offering them special protections.

If the debtor needs to incur unsecured debt outside the ordinary course of business during the pendency of the chapter 11 case, it must obtain approval of the Bankruptcy Court under section 364(b) of the Bankruptcy Code. To encourage lenders (“DIP Lenders”) to extend unsecured financing to a debtor, the Bankruptcy Code provides DIP Lenders with an administrative expense priority under section 503(b) of the Bankruptcy Code. Being granted a priority as an administrative expense means that a DIP Lender’s claim for repayment of the unsecured DIP Financing will have priority over all other pre-petition unsecured claims, which must be paid in full, in cash in order for the debtor to emerge from bankruptcy, unless otherwise agreed to by the lender.

Often, a simple administrative expense priority is insufficient to induce lenders to provide unsecured DIP Financing. If the debtor is unable to obtain unsecured financing, the Bankruptcy Court may authorise a debtor to obtain secured financing under section 364(c) of the Bankruptcy Code. Under section 364(c), the DIP Lender’s DIP Financing will be given a superpriority over any and all other administrative expenses of the estate along with a security interest in any unencumbered assets, or a junior lien on already encumbered assets. Credit obtained under section 364(c) not only requires the approval of the Bankruptcy Court, but also requires the debtor to prove to the court that it could not obtain financing on an unsecured basis.

If the debtor is still unable to obtain sufficient funding secured only by previously unencumbered assets and a junior lien on already encumbered assets, the debtor can obtain secured financing under section 364(d) of the Bankruptcy Code. Under that section, a debtor can also offer a priming lien, which is a lien on collateral senior to existing, pre-petition liens on such collateral and requires the DIP Lender’s claims to be paid prior to the payment of claims by the existing lenders secured by the same collateral, regardless of whether the source of payment is the sale of proceeds of the common collateral. Financings under section 364(d) are similar to financings authorised under 364(c) in the sense that this section is only available to the debtor if the debtor proves to the Bankruptcy Court that, without a priming lien, it could not otherwise obtain such financing. This ability to offer a priming lien on already encumbered assets is not available outside of chapter 11 and is one of the primary reasons that debtors can attract DIP Financing in chapter 11 when access to credit, even secured debt, was unavailable outside of bankruptcy.

While the ability to prime liens is of great benefit to DIP Lenders, because of the impact such liens have on the interests of the existing secured lenders, the Bankruptcy Code provides significant protections to the existing lenders whose liens are being primed. If the debtor seeks to prime existing liens, the debtor must either obtain consent from the lenders being primed.
or it must ensure that the interest of such lenders in the collateral is adequately protected against diminution of value resulting from the priming. Adequate protection, as defined in section 361 of the Bankruptcy Code, may include:

1. a cash payment or periodic cash payment by the debtor to the creditor to the extent that the value of the creditor’s collateral depreciates or otherwise decreases;
2. an additional or replacement lien to make up for any decrease in the value of the creditor’s collateral; or
3. granting such other relief as will result in the realisation of the “indubitable equivalent” of the creditor’s interest in the collateral.

Existing lenders will typically resist getting primed and will challenge the adequacy of the protections being offered. Insofar as a contested priming fight can be a very difficult, highly contentious, and destabilising proceeding for the business, debtors typically try to avoid a “priming fight” in the early stages of its case and will seek consent from the existing lenders or negotiate with them to provide the DIP Financing. As a result, the priming DIP Financing is generally provided by existing lenders who prime their own existing liens as well as the liens of the co-lenders who do not participate in the DIP Financing.

**Additional DIP Lender Incentives**

There are a number of other reasons why a lender would be attracted to providing DIP Financing. First, DIP Financing typically provides lenders with relatively higher rates of interest than they would otherwise receive outside of chapter 11. The highest interest rate for DIP financings in 2019 was 20% in the chapter 11 cases of Remnant Oil and Generation Next Franchise Food Brands. On a sector basis, the highest interest rates came from the technology sectors, averaging 11.3% overall, followed by the energy sector at 8.6%, and the consumer staples sector at 8.3%.

In addition, DIP Financing is a way for the debtor’s existing lenders to safeguard the value of their existing loans to the company. In many cases, were the debtor forced to liquidate precipitously after running out of funds, such lenders would almost certainly be faced with significantly lower recoveries on their loans. DIP Financing signals to vendors and customers that the debtor has sufficient capital to continue operations during the bankruptcy process or to conduct an orderly sale or liquidation process that can help maximise the existing lender’s recovery.

Furthermore, existing secured lenders may provide the DIP Financing as a defensive measure, as they may not want outside lenders to obtain junior or priming liens on the collateral that is already securing their loans or senior liens on unencumbered assets. Given their existing investment in the company, existing lenders often want to control their own destiny by providing the financing and dictating the direction and timeline of the chapter 11 proceeding. They risk losing such control if a third party lender comes in and provides the DIP Financing.

Lenders are always able to exert some control over their borrower through negotiated covenants in loan documents outside of bankruptcy. However, since typical corporate lending is not set up to closely monitor the borrower and close supervision has in some cases resulted in lender liability claims, outside of bankruptcy, lenders are typically hesitant to micromanage a borrower’s actions. DIP Lenders’ third party monitoring expenses are paid by the debtor. Moreover, the terms of their loans and the controls placed up on the debtor are approved by the Bankruptcy Court, and thus DIP Lenders are insulated from lender liability and similar claims. DIP Lenders can exert significant control over the debtor by requiring, among other things, strict compliance with an agreed-upon weekly budget and financial and non-financial covenants, detailed and frequent reporting, appointment of a chief restructuring officer acceptable to the DIP Lenders, and compliance with milestones for a condensed chapter 11 timeline.

While these controls keep a tight rein on the debtor’s expenditures and provide the lender with very early warnings if the company deteriorates further, the DIP Financing milestones also provide the DIP Lender with significant control over the timing and direction of the case. For example, the DIP Financing may require the debtor to obtain court approval of a chapter 11 plan on an expedited timeline. The DIP Financing may also require a sale of substantially all of the debtor’s assets under section 363 of the Bankruptcy Code if the plan milestones are not met.

Where the DIP Lenders do not believe that a reorganisation of the debtor will be feasible or where they believe such reorganisation would be too costly or time-consuming, the DIP lenders may require the debtor to engage in a sale process quickly at the outset of the case. For example, given the current market pressures in the retail space, it is not uncommon for DIP Lenders providing financing to retailers to require a sale to occur within the first 30 to 60 days of the bankruptcy case.

A Bankruptcy Code 363 sale may be required by the DIP Financing (either from the outset or due to the debtor failing to meet a milestone). In such event, the DIP Lender has the advantage of being able to credit bid its secured claim under section 363(k) of the Bankruptcy Code. With a credit bid, a DIP Lender can use the amount of its secured claim to pay all or a portion of the sale price in an auction for the assets being sold, which protects the DIP Lender’s interest in its collateral and ensures that its secured claim will not be undervalued.

Finally, existing pre-petition lenders that provide the DIP Financing may also negotiate for other special protections such as roll-up and cross-collateralisation provisions to ensure that their pre-petition claims are given priority over the claims of other pre-petition creditors. Roll-up provisions typically require the debtor to draw on the DIP Loan to pay off either some or all of the lender’s pre-petition claims. In other words, the lender’s pre-petition debt is “rolled up” into post-petition debt, which improves the lender’s prospect of receiving a recovery on its pre-petition investment by elevating its pre-petition claim to a post-petition secured claim with a superpriority administrative expense status.

Cross-collateralisation is another avenue the parties may take to achieve the same result. Those provisions grant a debtor a security interest in otherwise unencumbered assets of the company for both the DIP Lender’s pre- and post-petition claims.

It is worth noting that neither roll-ups nor cross-collateralisation are expressly authorised under section 364 of the Bankruptcy Code. Further, the improvement of the status of a DIP Lender’s pre-petition claim over that of similarly situated pre-petition claims also conflicts with the general bankruptcy equitable principle that members of the same class of pre-petition claims receive equal treatment. Nevertheless, if the debtor has no other source of financing and lenders will not otherwise extend credit to the debtor without such provisions, Bankruptcy Courts frequently approve these provisions.

Lenders in syndicated credit facilities often take advantage of these benefits, as well as the ability to prime liens, to advance their position over the other lenders within their credit facility. It is not unusual for several of the largest lenders under the existing facility to propose a DIP Financing that rolls up the pre-petition debt of the participating lenders and primes all of the liens securing the credit facility held by the non-participating existing lenders. If this group of lenders comprise the “required lenders” under the credit agreement, they may be able to direct the agent to consent to the priming of the liens.
and through the roll-up. Upon the roll-up, both the new money as well as their existing loans will become senior to the other lenders with whom they were previously pari passu. Of course, the minority lenders often object to such financing and may afford the opportunity to participate in the financing to resolve their objections.

Negotiating DIP Financing

Negotiating the DIP Financing is often undertaken during a compressed period of time, while the company is under significant financial strain and on the verge of running out of money. Given that the debtor is in extremis and often has no other options, DIP Lenders have significant leverage. Nevertheless, the Bankruptcy Court approval process helps to balance the leverage as the Bankruptcy Court may ultimately not approve provisions that it views as too onerous.

When negotiating the DIP Financing, as in an initial matter, the parties must agree on the type of chapter 11 case such as whether the case will involve a quick liquidation, an organised sale process or a lengthier reorganisation proceeding. Based on that, the parties must negotiate and agree upon the amount of financing needed and the structure of the loan. Depending on the anticipated length of the chapter 11 case and the agreed use of proceeds, the DIP Financing may be comprised of a term loan and/or a revolving credit facility (including asset-backed facilities). The parties also must negotiate the economic terms, the collateral securing the DIP Financing, including the interests to be primed, affirmative and negative covenants and other special protections like roll-ups and cross-collateralisation.

Determining the amount of DIP Financing required for a chapter 11 process is more complicated than simply determining the amount of money needed to keep the business’ operations running at the status quo and pay for the chapter 11 case. It also involves a strategic analysis of how new financing might impact the perception of the company among its vendors and suppliers. Often, by the time a company has filed for bankruptcy, all trade credit has dried up and the company is operating on a cash-on-delivery basis. A key assumption in any DIP Financing budget is whether and how quickly trade credit will return. Given the strict budget compliance requirements, wrong assumptions on issues such as trade credit can quickly lead to a default under the DIP Financing.

DIP Financings are evidenced by loan documents that can be based on the loan documents for the debtor’s existing debt. Even though the Bankruptcy Court order is sufficient to constitute a perfected priority security interest on collateral, DIP Lenders will typically document their security interests in collateral and take actions otherwise required by law to perfect those security interests. While it is generally the case that DIP Financings are made pursuant to executed loan documents, the Bankruptcy Court has the ability to approve DIP Financing terms, including priming liens, based on a term sheet which it may do under exigent circumstances, and the debtor and DIP Lenders will subsequently negotiate and execute loan documents.

Court Approval of DIP Financing

In any situation requiring court approval for DIP Financing, the debtor will need to file a motion with the Bankruptcy Court for authorisation to obtain post-petition credit (“DIP Motion”). The DIP Motion will be accompanied by the proposed order to be granted by the court (“DIP Order”), the underlying loan documents, as well as affidavits by the debtor explaining the process by which the financing was obtained and the need for the financing. Frequently, due to the short time frame before the filing, the parties are still negotiating the loan agreement when the motion is filed, so they may only attach to the motion a commitment letter or drafts of the loan agreement.

Approval of the DIP Financing is often a two-step process. As the DIP Motion is often filed on the first day of the bankruptcy case without the opportunity for the creditors of the debtor to receive more than a day or two’s notice, the Bankruptcy Code only permits the bankruptcy judge to grant interim approval of the amount of the DIP Financing necessary to avoid irreparable harm to the debtor. The Bankruptcy Court will then hold a hearing during the first few days of the case to consider approval of disbursement of a portion of the DIP Financing on an interim basis. Thereafter, notice of the financing will be provided to all of the debtor’s creditors and the court will hold a hearing at least 14 days later to consider final approval of the DIP Financing.

Because of the bifurcated hearing process, it is fairly common for creditors and creditors’ committees to raise objections to the financing at the final hearing. Often, these objections will focus on the milestones and other controls placed on the debtor by the lender, the roll up and/or cross collateralisation and other protections and benefits built into the DIP Financing. Whether the court will approve these provisions despite the creditors’ objections will often depend on the court’s perceptions as to whether the lenders would still make the financing available even if the court cuts back or eliminates such protections and benefits.

Conclusion

With the continued need of chapter 11 restructuring for large and complex businesses, the importance of understanding the role that DIP Financing plays in such restructurings remains crucial to debtors and lenders alike. Financially distressed companies should allow as much time as possible to investigate the terms of all available sources of financing, and the challenges that each potential lender presents to its restructuring efforts. Lenders, on the other hand, should evaluate and weigh the benefits available as the provider of the DIP Financing. To do this, they must understand the full array of available protections and strategic control they may be able to exert on the debtor’s case to best position themselves and protect their pre- and post-petition investments.

Endnotes

1. During a chapter 11 case, the debtor generally continues operations and restructures its debt under the Bankruptcy Court’s protection and oversight, or can otherwise conduct an orderly liquidation or sale process. This is different than a chapter 7 case where a trustee is appointed to conduct a liquidation process.
2. A company operating under chapter 11 is referred to as the “debtor”. Because the debtor remains in possession of its assets and its board remains in place, it is referred to as the debtor in possession.
3. There are many factors that may affect a lender’s decision not to extend credit to a financially distressed company that has not yet filed for bankruptcy protection, such as potential avoidance actions or the impact of the automatic bankruptcy stay of creditor remedies.
5. Section 363 of the Bankruptcy Code provides, among other things, for the sale of a debtor’s assets free and clear of all liens, claims, encumbrances and interests of third parties.

Acknowledgments

The authors gratefully acknowledge the assistance of Kalman Oechs, special counsel, and Sari Rosenfeld, an associate, at Fried, Frank, Harris, Shriver and Jacobson LLP, in the preparation of this chapter.
Julian S.H. Chung is a finance partner resident in Fried Frank's New York office. Ms. Chung focuses her practice on the representation of large financial institutions and borrowers in commercial lending transactions, with an emphasis on senior secured finance for leveraged acquisitions. She also represents financial institutions and debtors in connection with restructurings and refinancing existing credit facilities.
Ms. Chung has been recognised as a leading practitioner by The Legal 500 in Finance: Commercial Lending and The American Lawyer has named her one of the top lawyers under the age of 45. She has been recognised as an Alumni Honoree by the Cardozo Law School Black, Asian, Latino Law Students Association and has been included in Lawyers of Color's 2019 Nation's Best list.
Ms. Chung is a member of the Firm's Diversity Committee as well as the Women's Forum Planning Committee, a representative group directing Fried Frank's Firmwide women's affinity group.
Ms. Chung received her J.D., cum laude, from Benjamin N. Cardozo School of Law in 1995 and her B.A., from New York University in 1992. She is admitted to practise in New York.

Fried, Frank, Harris, Shriver & Jacobson LLP
One New York Plaza
New York, New York 10004
USA
Tel: +1 212 859 8957
Fax: +1 212 859 4000
Email: julian.chung@friedfrank.com
URL: www.friedfrank.com

Gary L. Kaplan is a Restructuring and Insolvency partner resident in Fried Frank's New York office. He joined the Firm in 1998 and became a partner in 2005.
Mr. Kaplan has extensive experience in representing debtors and official and unofficial creditors' and equity committees in chapter 11 cases and out-of-court restructurings. He also represents significant creditors, lenders and third-party purchasers in connection with chapter 11 cases and out-of-court restructuring situations.
Mr. Kaplan regularly appears in bankruptcy courts throughout the United States on a wide range of issues. He also has extensive cross-border experience, including representing Contraladora Comercial Mexicana (CCM), Mexico’s third-largest supermarket retailer, in its financial restructuring, a transaction that was named “Restructuring Deal of the Year 2011” by both International Financial Law Review and LatinFinance.
Mr. Kaplan is consistently recognised by Chambers USA: America’s Leading Lawyers for Business as a leading individual in Bankruptcy/Restructuring and is consistently recognised by The Legal 500 in Finance: Corporate Restructuring. He was named an “Outstanding Young Restructuring Lawyer” in a special report in the April 15, 2007 issue of Turnarounds and Workouts. Previously, Mr. Kaplan served as a law clerk to the Honorable Marie Garibaldi, New Jersey Supreme Court.

Fried, Frank, Harris, Shriver & Jacobson LLP
One New York Plaza
New York, New York 10004
USA
Tel: +1 212 859 8812
Fax: +1 212 859 4000
Email: gary.kaplan@friedfrank.com
URL: www.friedfrank.com

Fried, Frank, Harris, Shriver & Jacobson LLP advises the world’s leading corporations, investment funds and financial institutions on their most critical legal needs and business opportunities. The Firm’s approximately 500 lawyers are based in North America and Europe.

www.friedfrank.com