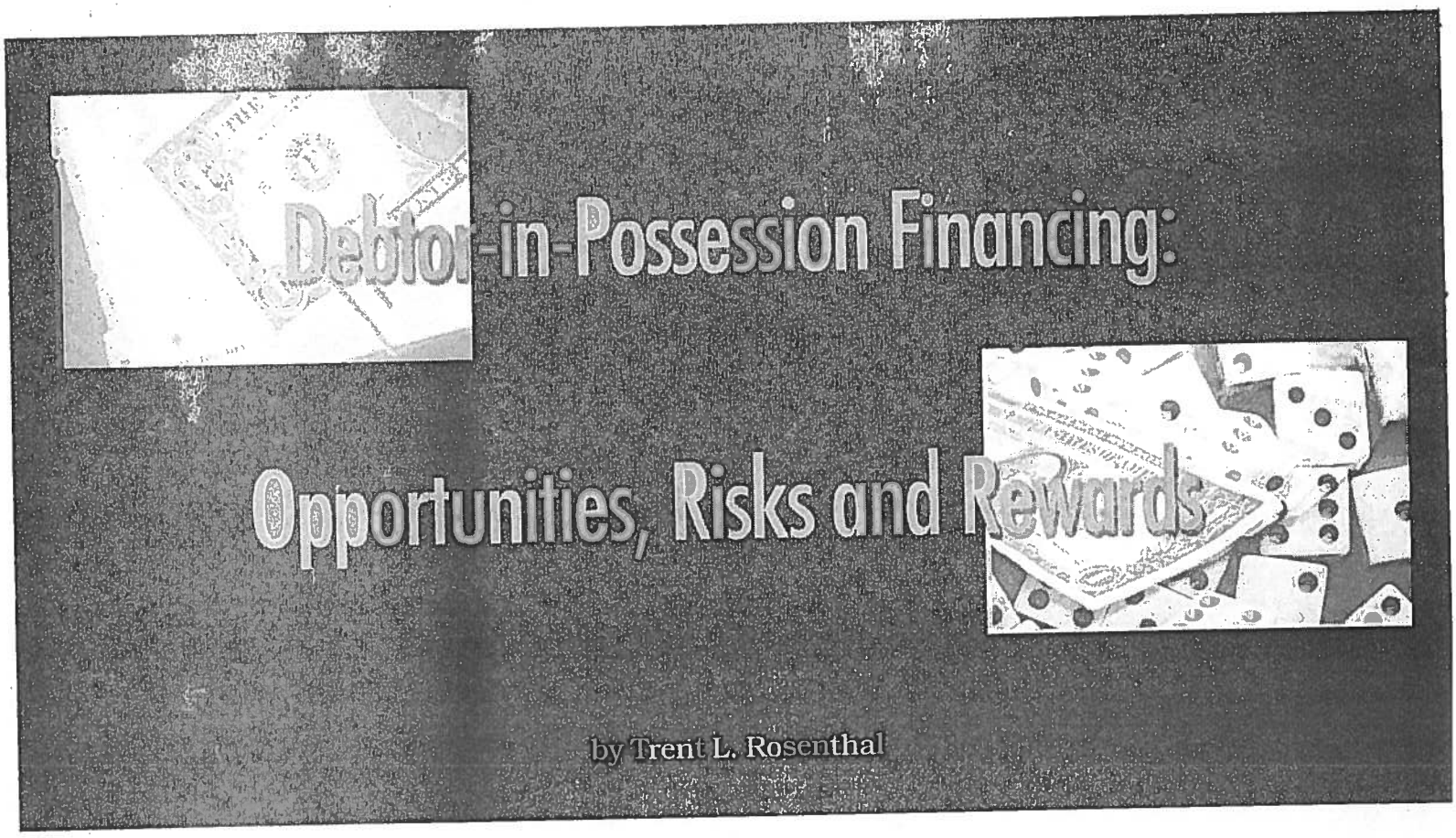

Debtor-in-Possession Financing: Opportunities, Risks and Rewards

by Trent L. Rosenthal

The market for debtor-in-possession (DIP) lending is fiercely competitive, but it can be very rewarding. Even the United States Supreme Court in its recent decision in *Till v. SCS Credit Corp.*, 124 S. Ct. 1951 (2004), noted the existence of a free market for lenders advertising financing for Chapter 11 debtors-in-possession. In some cases, DIP lending can be less risky than other types of loans, and it presents a unique opportunity for knowledgeable lenders to make loans with higher yields and more profits than might be available outside the bankruptcy context. An increased return is justified by what the market perceives as increased risk, but many protections are available to help reduce risk. While the lender might not get everything it wants, it usually receives sufficient protections to assure repayment. DIP loans differ from typical secured loans, and the DIP lender and its counsel should understand the special characteristics. Counsel should be actively involved in negotiating the terms of the DIP loan and should insist that protective provisions be approved by the Bankruptcy Court as a condition to making the loan.

The DIP lender should first assess the value of the collateral. Due to the competitive market for DIP loans, DIP lenders might be tempted to short-circuit this step in order to obtain the business, or might forgo full appraisals and instead rely on other valuations. However, DIP loans are almost always asset-based, and assessing the collateral's value, whether as a going concern or in a liquidation context, is absolutely critical. In most cases, the DIP loan is repaid in full as part of the debtor's emergence from Chapter 11. Typically, the debtor obtains an exit facility that takes out the DIP loan. In a recent telecom case, however, the DIP lender was not so lucky and faced a tremendous deficiency. Failing to assess the value of the collateral in a liquidation at the inception of the DIP loan was disastrous. All the safeguards in the world will not protect the DIP lender if there is insufficient collateral and the debtor does not otherwise have sources of funds to repay the loan.

Chapter 11 lawyers receive frequent calls from DIP lenders looking for the opportunity to provide DIP financing. Some prospective DIP lenders even use the Internet to search for recent corporate Chapter 11 filings using PACER, an electronic access system for bankruptcy filings. A DIP lender prospecting for these types of loans should understand what is important from the point of view of the Chapter 11 lawyer.

One of the most important considerations for a lawyer assisting a debtor client in obtaining a DIP loan is the speed at which the DIP lender can respond to the loan request. Timing is critical because the debtor will need funding to maintain its business and, in some cases, to pay its professionals. A Chapter 11 lawyer usually has established a relationship with a DIP lender known to respond quickly — one with an established track record of success (i.e., the lender has approved and funded similar types of DIP loans). Although most Chapter 11 lawyers are open to establishing new relationships with capable lenders, the relationships usually result from the lawyer having seen the lender's responsiveness on another case or the lender

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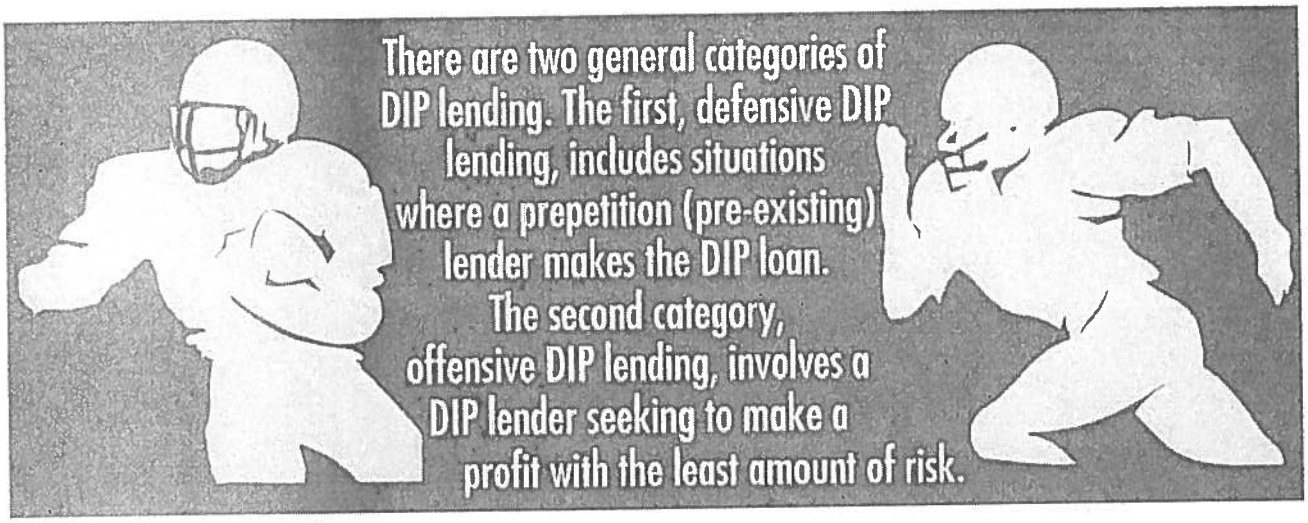

having been referred by a turnaround professional. The lawyer is looking for "no hassle" lending from a DIP lender that understands the process and has successfully made DIP loans in other cases.

The statutory framework governing DIP loans is Section 364 of Title 11 of the United States Code, commonly referred to as the Bankruptcy Code, which permits several types of loans to debtors. For debt in the ordinary course of business, such as trade debt, Section 364(a) allows the debtor or trustee to incur such debt without an order of the Bankruptcy Court, and the debt is recoverable as an administrative claim. Such claims are on equal par with the claim of lawyers, professionals and other postpetition trade credit in the case. It does not provide absolute protection because some debtors are administratively insolvent, i.e., lacking sufficient unencumbered funds available to pay administrative claims.

Because DIP loans are not in the ordinary course of business, and because the DIP lender usually requires something more than an administrative claim, it is necessary to obtain and seek prior bankruptcy court approval before making the loan. Under Section 364 (c) of the Bankruptcy Code, the bankruptcy court may authorize the debtor to obtain credit or incur debt that (1) has priority over any or all administrative expenses, (2) is secured by a lien on property of the estate that is not otherwise subject to a lien, or (3) is secured by a junior lien on property of the estate that is subject to a lien.

If the debtor still cannot obtain a loan on the foregoing basis, Section 364(d)(1) empowers the bankruptcy court to authorize the debtor to obtain a loan that is secured by a senior or equal lien on property of the estate already subject to a lien. This is commonly referred to as a "priming lien," and it effectively subordinates a current lien on the property to a lien securing the new debt. For this to occur, however, the debtor must prove to the bankruptcy court that the existing lienholder will have "adequate protection" of its lien, i.e., the lender's interest in the collateral will not be reduced or impaired as a result of the loan. Adequate protection requires that the first lender be given the "indubitable equivalent" of its interest in the property after the loan, and Section 361 of the Bankruptcy Code discusses the forms of adequate protection. As an example, if the new DIP loan will decrease the value of the first lender's lien, the first lender must be granted replacement liens to that extent.

To protect the DIP lender in the event the order approving the loan is reversed on appeal (i.e., someone convinces a higher court that the bankruptcy court should not have approved the DIP loan), Section 363(e) provides that the reversal or modification on appeal does not affect the validity of any debt or the priority of any lien so granted to an entity that extended the credit in good faith, even if the entity had notice of the appeal, unless there was a stay pending appeal. Obtaining a stay usually requires the appealing party to post a bond. Thus the provision makes it difficult and impractical for creditors to appeal. Without this provision, a creditor or committee could effectively hold the debtor hostage by threatening to appeal any order approving a loan, which would dissuade potential lenders from making interim loans. Because it protects DIP lenders acting in good faith, the provision fosters a debtor's reorganization effort and recognizes the expedited nature of the debtor's need to borrow critical funds to continue with its reorganization.

There are two general categories of DIP lending. The first, defensive DIP lending, includes situations where a prepetition (prexisting) lender makes the DIP loan. The reasons for this vary, but a prepetition lender might use the opportunity to enhance its prepetition position or to make a profit on the DIP loan in order to offset a loss on the prepetition loan. With its considerable information concerning the debtor's financial condition, the prepetition lender usually is in an excellent position to offer such financing and to make a quick underwriting decision. An ancillary benefit of defensive DIP lending is that it obviates the need to deal with a new lender and any related lien-priority issues.

The second category, offensive DIP lending, involves a DIP lender seeking to make a profit with the least

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amount of risk. A subcategory of the "for profit" loans includes situations in which the DIP lender is making the loan with the goal of acquiring the debtor or assets from the debtor. This strategy can be effective where the debtor is out of money and has no other source of funds, and there are strategic reasons for a debtor to borrow money from a potential purchaser.

Once the DIP lender is selected, the terms of the DIP loan must be negotiated. Sometimes this can be a one-sided negotiation due to the debtor's need for funds and the lender's corresponding bargaining strength. Nevertheless, the lender should recognize that, even if the debtor is willing to agree to unfavorable terms, the creditors can object, and the bankruptcy court might not approve the loan in any event. Additionally, if one DIP lender is taking an unreasonable position on an issue, the debtor might look elsewhere for the money, resulting in the loss of a good opportunity for the lender. Counsel for the debtor usually is knowledgeable about what can be expected in a particular DIP loan. It makes more sense for the lender to negotiate the terms of a fair and workable DIP loan from the inception — one with terms consistent with loans made and approved in other Chapter 11 cases.

The terms and conditions of the DIP loan should be documented in a written commitment. Many lenders on larger facilities require the debtor to pay certain upfront fees and advance costs, including the DIP lender's attorney's fees. Some DIP lenders require the debtor to obtain bankruptcy court approval of the commitment before it proceeds with final loan approval. In the fast-paced setting of most DIP loans, this might not be possible. Until the DIP loan is finally approved by the bankruptcy court, there is always the risk the debtor will be offered a better deal by another lender. This is not commonplace because of the substantial due diligence typically done by the lender in connection with approving the DIP loan and the speed at which the DIP loans are usually approved. However, if the committee is active and the proposed DIP loan is grossly unfair, the committee may object to the DIP loan and insist that the debtor look elsewhere for the money or not borrow the money at all. These factors militate in favor of making the DIP loan fair for everyone from the start.

Because the law is not entirely uniform between jurisdictions as to what terms can be included in a DIP loan, the DIP lender and its counsel should be aware of the local rules and procedures. Some courts have adopted local rules to specifically deal with DIP loans. Other courts have issued letters, guidelines or other rulings as to what they will, or will not, approve in a DIP loan. For example, Judge Walsh from the United States Bankruptcy in the District of Delaware has issued a letter outlining his views on certain provisions of DIP loans. Judge Walsh's guidelines present a practical approach to dealing with DIP loans. There has been a movement to standardize the practice from jurisdiction to jurisdiction; however, various provisions may be approved or objectionable, depending on the court. At one point, it was believed by some bankruptcy lawyers that cases were filed in particular jurisdictions because the court there was more likely to approve DIP loans on an expedited basis and on terms required by the lender.

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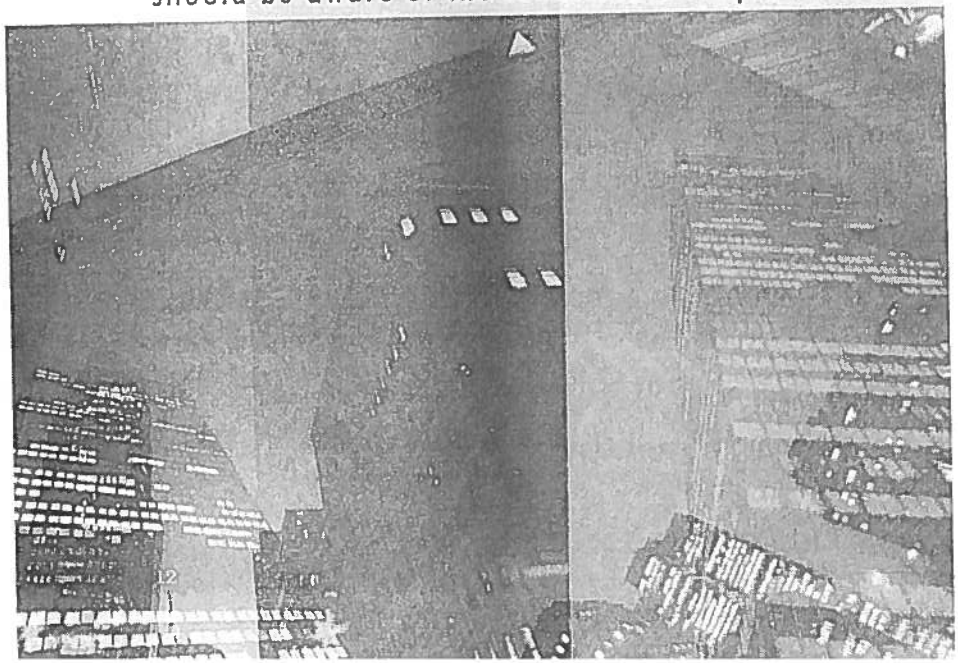

On the first day of a Chapter 11 case, the debtor typically seeks approval of the DIP loan on an expedited basis by motion. The court will likely conduct an expedited hearing on the request and issue an interim order. A final hearing then will be held on the debtor's request to approve the DIP loan. Because notice of the first expedited hearing is usually very limited, and because the court is asked to make a determination on the DIP loan at the very early stages of the case, provisions that ultimately will be contained in the final DIP order might not be appropriate for inclusion in the interim DIP order. Until the final DIP order, the court or the DIP lender might restrict the amount of borrowing to amounts necessary for essential expenses. A DIP lender that advances funds on the interim basis will have substantial protections as to the monies it advances, but perhaps not all protections it has requested as part of the final approval of the DIP loan.

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Some common provisions of DIP loans and why they are important include the following:

Confirmation of liens and releases: As part of any debtor-in-possession financing, the lender should require the debtor to confirm the validity, extent and priority of the lender's prepetition claim and lien and should seek a release of claims by the debtor. This is most important in defensive DIP lending, where the lender is making the loan to protect or enhance its prepetition position. Courts have approved such releases if convinced that the debtor would be unable to reorganize without the loan and that the release is appropriate under the circumstances — particularly where the debtor has had an opportunity to investigate the claims. The court will be asked to approve the lien confirmation and release in the order approving the financing. In some cases, the only reason the DIP lender is making the loan is in order to obtain a release and confirmation of its liens. Bankruptcy courts usually allow an investigation period (i.e., 60 days after entry of the order) during which other parties may challenge the lender's claim and lien. However, most courts allow the debtor to agree not to contest the lender's claims and liens as a requirement of the postpetition credit facility. Once the investigation period concludes, the lender's position is enhanced. The lender no longer will have to worry about a challenge to its lien of claim. The benefits of a release and lien confirmation are obvious — the DIP lender can potentially avoid litigation and the associated risks. If the debtor does not really have any valid contest of the lender's claims or claims against the lender, then the debtor should not really care about releasing something with no value.

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Cross-collateralization: Lenders providing postpetition facilities can seek not only liens on postpetition assets to secure the debtor-in-possession financing facilities, but also liens on prepetition collateral. This type of cross-collateralization is frequently granted. Lenders may demand liens on postpetition collateral to secure the prepetition debt, which would typically be requested in a defensive DIP loan, where the DIP lender is attempting to enhance its position. Cross-collateralization is sometimes difficult to obtain. Cross-collateralization can substantially improve a lender's position if the prepetition collateral does not have sufficient value to cover the lender's claims. As an alternative to cross-collateralization, some postpetition DIP lenders advance monies to pay off

the prepetition secured loan in what has been referred to as a "roll-up". The prepetition debt is converted to a postpetition debt, with the same assurances of repayment as the DIP loan.

Liens: A blanket lien on all assets to secure the debt is most common. The liens can be either of equal priority with the current prepetition liens, or can be superior to the liens. Since it is more difficult to prime the prepetition liens (i.e. adequate protection of the first lien has to be proven), many DIP loans propose to pay off the prepetition liens with the proceeds from the DIP loan. Some courts disfavor liens on a debtor's avoidance actions and believe that such actions should be available for unsecured creditors. However, other courts have approved the granting of liens on these actions. This is a fact-intensive question and varies by jurisdiction.

Timeline for Chapter 11: Lenders can establish timelines and milestones for the debtor to take certain actions, facilitating a quick emergence from Chapter 11. In an offensive DIP loan, the lender may also include proce-

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dures for the auction and bidding on the debtor's assets. The lender may also require break-up fees, termination fees, and expense reimbursements if the lender does not end up with the assets. In an offensive lending situation, the lender will also usually require that the loan be re-paid upon the sale of the assets to a third party.

Fees and term: The DIP facility should clearly establish the interest rate, fees and expenses associated with the DIP loan so that future disputes can be avoided. The facility should provide for a definite date upon which repayment is due, which may be tied to the date a plan is confirmed or may be an outside date.

Default provisions: Provisions that allow the DIP lender to exercise its rights upon default are important. While some courts require the DIP lender to return to court in the event of default, the DIP lender will likely want to include default provisions that allow the lender to exercise its rights without court intervention. In all cases, the facility should clearly establish the rights and remedies of the DIP lender in a default situation. DIP lenders insisting on the right to exercise remedies upon default without at least bringing the issue to the attention of the Bankruptcy Court are overreaching. A reasonable position could be that the DIP lender will file a default notice with the court and, if no objections are filed and no injunction is obtained, the DIP lender can thereafter exercise its rights.

DIP lending can be very lucrative; however, not every lender is prepared to seize the opportunity to provide DIP loans. Instead, the educated DIP lender that is familiar with the process can stand to gain the most while risking the least. A relationship with a Chapter 11 lawyer, and knowing what to expect in the process, will increase the lender's chance of success. ▲