

***PRACTICAL ISSUES IN
DEBTOR-IN-POSSESSION FINANCING***

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I. INTRODUCTION

Businesses typically need financing, whether in the form of receivables factoring, operating lines of credit (unsecured or secured against a collateral borrowing base), terms other than COD from inventory suppliers and vendors, or secured debt. The need for financing can be the most acute when the business needs bankruptcy protection to pare down its operations, facilitate a sale of all or part of the business or assets, or, more typically, to stave off foreclosures, repossessions, cessation or reduction of available credit, or other contractions in the face of loan defaults.

Many businesses that ultimately file a Chapter 11 case do not adequately anticipate the need for debtor-in-possession post-petition financing (“**DIP Financing**”) in the throes of a financial crisis. Those that do plan in advance have observed declining metrics, given focused attention to alternatives and prospects, and consulted with potential lenders, turnaround professionals and bankruptcy counsel.¹ Unfortunately, many efforts to obtain DIP financing arise in an environment of panic, where a petition is being filed in response to some immediate credit crisis, particularly repossessions, interruption of credit facilities, or lawsuits. As a result, complex loan transactions that would take several days or weeks to consummate under normal business conditions, are often hatched in a matter of a few days or even a few hours. Adding to this environment is the fact that a

¹ Some debtors, knowing the state of the current credit markets, choose to file a Chapter 11 petition relatively early in the declining business cycle while their cash positions are substantial. For example, Trump Entertainment Resorts and its nine subsidiaries, which filed Chapter 11 petitions in Feb. of 2009, did not seek DIP financing “because it currently has adequate cash resources to fund its ongoing business operations.” “Gaming: Trump Entertainment Resorts Subsidiaries File Under Chapter 11 Seeking to Deleverage,” *Bankruptcy Law Daily*, Feb. 18, 2009. One 2003 study indicated that at least half of all publicly traded companies entering Chapter 11 did not need to obtain DIP financing. Sandeep Dahaiya, et al., “Debtor-in-Possession Financing in Bankruptcy Resolution: Empirical Evidence,” 69 *J. Finan. Econ.* 259, 266 (2003). Bankruptcies filed while companies have strong cash positions are referred to, appropriately, as “preemptive bankruptcies.” *Reuters*, Dec. 12, 2008. See Stephen A. Donato, Esq. et al., “Trends in DIP Financing: Not as Bad as It Seems?,” *J. Corp. Renewal*, Vol. 22, No. 8, at 5 (citing to the foregoing sources).

significant part of all DIP financing is provided by the invited guest, i.e., the prepetition lender, who is already attending the party by providing the existing credit facility.²

II. RECURRENT TENSIONS AND COMPETING INTERESTS IN DIP FINANCING

The DIP lending environment is a curious mix of skills, people, and dynamics, specifically:

- i. the creativity and thoroughness of lawyers drafting loan documents;
- ii. the need for quick underwriting decisions by the potential DIP lender, often the prepetition lender, in view of the debtor's deteriorated financial condition;
- iii. the skills of bankruptcy litigators in presenting necessary evidence to the court to approve the financing, often with little time to prepare;
- iv. the necessary reliance on standard form loan documents and orders due to the pace of most DIP lending transactions;
- v. the relative experience and sophistication of counsel and parties to the case, including the debtor, debtor's counsel, counsel to other creditors, the United States Trustee and others, with the DIP financing process; and
- vi. the recognition of the virtual certainty that without the financing, the debtor will fail.

This mix of ingredients which makes a volatile and unique brew. Some of the most prominent competing interests and tensions in the typical DIP financing situation are these:

A. Urgency.

There is typically very little time to negotiate and document the credit facility. Often the facility will be little more than a continuation of the prepetition lending arrangements where the DIP lender is the prepetition lender. Even if the facility is presented to the court with a well-developed term sheet or DIP financing agreement, there is typically little time to engage in protracted

² David B. Stratton & Evelyn J. Meltzer, "A Year in Review: Delaware DIP Orders in 2008," 28 Am. Bankr. Inst. J. 32, 32 (2009).

negotiations. This explains why the best DIP lender is one who anticipates that its borrowers will sometimes request DIP financing and that are, consequently, prepared for quick turnarounds with established credit policies, documents, and experienced counsel and lending officers who understand the post-petition lending environment.

B. Truncated Negotiations.

Because there is often so little time to negotiate, let alone because of the state of the credit markets, much DIP financing is offered on a “take it or leave it” basis. In other words, because there is typically little time to negotiate, negotiations are highly compressed.³

C. Need for Prompt Court Approval.

As discussed under the section concerning DIP financing approval procedures below, motions to approve DIP financing often come before the court as first day motions, under emergency circumstances, where the debtor needs daily cash infusions from receivables financing or other immediate credit for transportation, utilities, inventory, commissions, salaries, and similar immediate needs. Courts are then faced, by necessity, with complex proposed orders, term sheets and DIP agreements that require, for approval, detailed findings concerning good faith, irreparable harm, necessity, fairness, and related findings and conclusions necessary to support a financing order. In addition, the debtor frequently has obtained, from a prepetition lender who is becoming the DIP lender, daily disbursements in advance of even an emergency hearing in order to keep the debtor’s operations running (a typical example is fuel purchases for a trucking company). In that

³ If a prepetition lender, for example, believes it is prudent to be the debtor’s DIP lender, in circumstances where the lender wishes to assist in preserving the going concern value of the debtor and the petition is filed in haste, time to negotiate a full DIP credit agreement can be created by “financing” the debtor with the use of emergency and interim cash collateral orders which provide both use of cash collateral (with the assumption that the prepetition lender holds liens on cash) and DIP financing, which orders contain many of the essential terms found in typical DIP financing orders. For a case in which the author represented the DIP lender and used this strategy, *In re 1st Carrier Corp.*, No. 09-17116 (Bankr. S.D. Ind. filed Nov. 23, 2009).

situation, the court is also faced with the request to approve the financing *nunc pro tunc* to the petition date.

D. Lack of DIP Financing Experience.

Frequently, particularly in medium size cases, many of the creditors and their representatives have little familiarity with the DIP financing process and environment, let alone applicable law. As a consequence, these parties will reactively object to the DIP financing out of fear of acceding to what appear to be sweeping and overbroad provisions. This situation heightens the need for debtor’s counsel and lender’s counsel to work closely together to present to the Court the necessity, fairness, and legal support for approval of the facility. Debtor’s counsel should avoid the temptation to use non-lending creditors, the United States Trustee or other constituencies as battering rams to obtain better lending terms. Doing so only increases the risk of drawing unnecessary and ill-advised objections, which increases the risk that the credit offer will be withdrawn.⁴

⁴ A debtor cannot compel a prepetition lender to lend post-petition under theories of assumption of executory contracts under Section 365(a), or theories of use of cash collateral under Sections 361 and 363 (as to additional advances beyond cash collateral in existence as of the petition date.) Agreements to extend “credit facilities,” such as loans and factoring facilities, are non-assumable “financial accommodations” as that term is employed under Section 365(c)(2). *See, e.g., Reaves Brokerage Co., Inc. v. Sunbelt Fruit & Vegetable Co., Inc.*, 336 F.3d 410, 414-17 (5th Cir. 2003); and *BNY Financial Corp. v. Master Wear Corp (In re Master Wear Corp.)*, 229 B.R. 301, 308 (Bankr. S.D.N.Y. 1999). “[Section 365(c)] permits the trustee to continue to use and pay for property already advanced, but is not designed to permit the trustee to demand new loans or additional transfers of property under lease commitments.” H.R. REP. 95-595, 1978 U.S.C.C.A.N. 5963, 6304. *See generally In re T.S. Industries, Inc.*, 117 B.R. 682, 685-89 (Bankr. D. Utah 1990) (analyzing the legislative history of Section 365(c)(2); *In re Ernie Haire Ford, Inc.* 403 B.R. 750, 757 (Bankr. D. Fla. 2009) (discussing legislative history of Section 365(c)(2)).

The purpose of this non-assumability restriction is to prevent “unfairly elevating the risk to a party who extended credit prepetition.” *In re Best Products Co., Inc.*, 210 B.R. 714, 718 (Bankr. E.D. Va. 1997); *See also Foothill Capital Corp. v. Official Unsecured Creditors’ Committee of Midcome Communications, Inc.*, 246 B.R. 296, 300 (Bankr. E.D. Mich. 2000) (citing *Tully Constr. Co. v. Cannonsburg Envtl. Assocs. (In re Cannonsburg Envtl. Assocs.)*, 72 F.3d 1260, 1266 (6th Cir. 1996)).

This section of the Code detached the function of prospective financing from existing credit arrangements. *Transamerica Commercial Financial Corporation v. Citibank, N.A. (In re Sunrunner Marine, Inc.)*, 945 F.2d 1089, 1092 (9th Cir. 1991); *In re Quad-Cities Const., Inc.*, 254 B.R. 459, 470 (Bankr. D. Idaho 2000) (citing *Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)*, 165 F.3d 747, 753 (9th Cir. 1999)).

E. Lack of Available DIP Lenders.

The current credit markets are tight, and DIP lending is difficult to find. This has led to more stringent lending terms and availability. Events such as General Electric's decision to largely halt lending to companies in bankruptcy, the failure of Lehman Brothers (which had been a significant DIP lender until its decline into bankruptcy), and the sales of Merrill Lynch and Wachovia Bank (both of which had sizeable units that made DIP lending a specialty) have worsened the situation. Other DIP lenders have "pulled in their horns" upon seeing so many major players exit the field.⁵

III. WHY WOULD ANY LENDER WANT TO LOAN MONEY TO A BANKRUPTCY DEBTOR?

To members of the general public, loaning money to a company that has filed bankruptcy is completely counterintuitive. The borrower is already sinking, and it would seem that the filing of the bankruptcy case simply guarantees that the borrower will drag any lender down with it. There are, however, sound reasons for a lender to extend DIP financing to a debtor. These reasons are as many and varied as the lenders themselves.

A. To Protect the Debtor's Going Concern Value and the Prospects for Loan Repayment Prospects.

As noted above, some of the most common DIP lenders are the debtor's prepetition lenders. The debtor may require bankruptcy relief to protect its going concern value from precipitous actions by creditors, other than the prepetition lender, in circumstances where the debtor has otherwise performed under the terms of the lender's prepetition credit facility. For example, consider a long-haul trucking company that might have a prepetition working capital line with the lender and perhaps fleet equipment loans or fuel facilities with that same lender. Another large equipment lender might refuse to restructure the debtor's equipment facilities, and then threatens to repossess

⁵ Donato, *supra* note 1, at 5.

its collateral, which will in turn cause the debtor to lose a key customer relationship with a large and financially sound shipper, because of inadequate fleet size. Similarly, the same debtor's physical terminal facilities might be subject to foreclosure, receivership or seizure.

In these examples, the prepetition lender has underwritten the prepetition credit facilities with the assumption that the debtor will continue as a going concern. Allowing key assets not financed by the prepetition lender to be repossessed will result in the cessation of the borrower's business, and create a considerable risk that the prepetition lender will not be repaid from its prepetition collateral. This risk may be obviated by continuing the prepetition facility as a DIP loan. In scenarios similar to this example, the lender may be able to obtain favorable treatment of its secured debt, and the bankruptcy petition will allow its customer, the debtor, to stay the actions of the other creditor and perhaps bifurcate that creditor's claims, or otherwise restructure the debt. To advance DIP financing for this reason, the lender should have the benefit of circumstances where bankruptcy relief will allow the debtor to deal swiftly and effectively with the other creditor.

B. Maintenance or Improvement of a Profitable Lending Relationship.

Lenders, particularly those inclined to engage in DIP lending, are not charitable institutions. They are in it to make money. Often, as seen in the trucking company example stated above, the prepetition lender has a profitable working capital relationship, such as a borrowing base comprised of receivables due from financially sound obligors. The DIP credit facility may be underwritten and structured in a way that provides the prepetition lender turned DIP lender with the opportunity to make an effective exit from the facility in the event of default. The DIP lender may essentially continue the prepetition facility into the DIP loan, but take the opportunity to reassess the risk and to raise interest rates, raise reserve requirements, enhance or tighten covenants and yield guarantees, and charge new fees as a DIP lender.

C. Maintaining Customer Good Will.

The debtor could be a long-time strong customer of the prepetition lender whose principals may have other valuable customer relationships with the lender, either personally or through other businesses. In addition, the debtor requesting DIP financing from a prepetition lender may be merely a subsidiary or an affiliated business of a much larger and more creditworthy customer. Provided that the DIP loan is underwritten in accordance with sound lending practices (or regulatory requirements in the case of a regulated financial institution), the DIP lender can maintain or increase tremendous good will with the customer by providing DIP financing.

D. Improvement of Position and Resolution of Disputes.

Another sound reason for a prepetition lender to provide DIP financing is to (i) correct insufficiencies in the perfection of its prepetition security interests in collateral, (ii) repair ill-advised or poorly drafted loan terms, which can exist in loans purchased by the lender in addition to loans made by the lender itself, (iii) improve credit yields, and to resolve any simmering disputes. Because the debtor cannot compel a prepetition lender to be the debtor's DIP lender,⁶ the lender can improve its yields with increased rates, new fees and yield guarantees. In addition, as discussed more particularly below, Sections 364(c) and (d) of the Bankruptcy Code may permit the lender to resolve perfection problems on collateral, and shift priorities or resolve priority disputes in relation to other lien holders on the same collateral. For example, if there is a priority dispute as to an asset of the debtor among two prepetition lenders, the DIP lender, because it is willing to lend when the other creditor is not, may force a resolution of that priority dispute with a priming order under Section 364(d). In addition, it is very common for DIP lenders to require, as part of the DIP facility, acknowledgments from the debtor as to the perfection, priority, value, amount, and good faith of the prepetition facility and the waiver of claims and defenses. If there is a simmering lender liability

⁶ See *supra* note 4.

issue between the debtor/borrower and the prepetition lender, it is commonplace for the debtor to waive those claims in order to obtain the post-petition financing.

E. To Strengthen Controls and Reporting.

Sometimes the debtor's reporting and business controls are poorly designed and executed, but the prepetition lending documents do not provide for necessary restrictions and oversight.

When a prepetition lender becomes a DIP lender, it may insist on more frequent reporting, different forms of reporting, maintenance of procedures such as 13-week rolling budgets, restrictions on management salaries, restrictions on additional loans, liens, encumbrances, and dividends, and other, similar controls and restrictions. While there is always concern about overcontrol, such controls are often seen, and usually tolerated, in the DIP financing setting. For example, a DIP agreement can provide that the lender can install its own turnaround consultant (if not manager) under certain circumstances at the estate's expense. This is seldom the kind of provision seen in routine lending agreements.

F. Building a New Line of Business.

Lenders with reduced loan volume and fee income in the distressed economy may wish to open a new line of business by lending to debtors in possession. DIP loans, if structured and underwritten properly, can be very profitable. Lenders who are new to the debtor/customer can, in many instances, become a substitute DIP lender and take out the existing prepetition lender by offering better terms (if better terms are warranted). Many lenders, particularly non-traditional lenders, are seeking new markets to deploy their capital and obtain a higher return to investors. DIP lending also provides an environment where a lender can negotiate more profitable terms, shorter maturities, and greater oversight and control over the debtor's operations than the DIP lender could negotiate in circumstances outside of bankruptcy. Every company in bankruptcy recognizes that its bargaining position for lending has been diminished, which works to the advantage of DIP lenders.

G. To Provide Bridge Financing to a Section 363 or Plan Sale of Assets.

A significant part of all DIP financing is provided by the existing lender in order to sustain the debtor's ongoing operations until the debtor's assets can be sold in a sale under 11 U.S.C. § 363. This type of DIP financing can also be provided by a party having an interest in that sale, such as a potential purchaser itself or the intended financier of the ultimate purchaser.⁷

IV. A BRIEF HISTORY OF DEBTOR-IN-POSSESSION FINANCING

The provisions for DIP financing contained in Section 364 of the Bankruptcy Code were among the most basic and innovative provisions of the Bankruptcy Reform Act of 1978.

A. The Former Bankruptcy Act.

Section 364 is derived from the provisions of the former Bankruptcy Act. Section 364 is largely based on Section 116(2) of Chapter X of the Act, which authorized the issuance of certificates of indebtedness on a secured or unsecured basis. The limited language of the old section left it largely to case law to flesh out the conditions under which indebtedness might be incurred, as well as the standards to be applied in granting the new credit lien status with priority over existing liens. The current Section 364 of the Bankruptcy Code appears to be modeled largely after the result in *In re Chicago, Rock Island and Pacific Railroad Company*, 545 F.2d 1087 (7th Cir. 1976), where the Seventh Circuit adopted a more relaxed standard concerning proof of a "high degree of likelihood" of reorganization and other strict standards previously imposed for obtaining financing.

B. The Role of Case Law.

Case law is, nonetheless, continuing to play an important role in the tolerances that courts display toward certain DIP financing provisions. For example, conflicting rulings concerning

⁷ See, e.g., *In re Flying J Inc., et al.*, No. 08-13384, Dkt. Nos. 1493 and 1591 (Bankr. D. Del. filed July 28, 2009) (DIP Credit Agreement between Flying J, Inc. and Pilot Travel Centers, LLC; Pilot ultimately purchased Flying J's key operating assets, its travel centers, under the terms of a confirmed plan).

whether post-petition cross-collateralization is permissible in DIP facilities illustrates the role that case law still plays.⁸

Most courts measure the permissibility of any particular DIP financing provision against tests such as: (a) whether the debtor's business operations would fail absent the proposed financing; (b) whether the debtor is unable to obtain alternative financing on acceptable terms; (c) whether the proposed lender will not accept less preferential terms; (d) whether the proposed financing is in the general creditor body's best interests, and (e) whether but for the grant of the relief requested, the debtor would cease its business, such that the benefits to the creditors who may be affected by such extraordinary relief outweighs the harm to them, or at least leaves them no worse off.⁹

C. The Credit Marketplace.

The state of the marketplace for post-petition financing mandates increased tolerance by courts for "extraordinary relief" because the number of lenders in the insolvency space has decreased, and the terms of DIP lending have become more demanding. Several recent cases approved DIP facilities that featured cross-collateralization, rollup of prepetition debt into post-petition financing and other "extraordinary relief."¹⁰ A survey conducted of DIP orders entered in

⁸ Compare, *Shapiro v. Saybrook Manufacturing Co., Inc.*, 963 F.2d 1490, 1494-96 (11th Cir. 1992) (disallowing cross-collateralization); *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716 (S.D. Fla. Jul 14, 2010) (disallowing cross-collateralization) with *In re Texlon Corp.*, 596 F.2d 1092 (2nd Cir. 1979) (allowing cross-collateralization); *In re General Oil Distributors, Inc.*, 20 B.R. 873, 875-76 (Bankr. E.D.N.Y. 1982) (allowing cross-collateralization).

⁹ See, e.g., *In re Vanguard Diversified Inc.*, 31 B.R. 364, 366 (Bankr. S.D.N.Y. 1986), citing, *In re Roblin Indus., Inc.*, 52 B.R. 241, 244-45 (Bankr. W.D.N.Y. 1985); and *In re K-Mart Corp.*, 359 F.3d 866 (7th Cir. 2004).

¹⁰ *Linens Holding Company*, No. 08-10832 (Bankr. D. Del. filed May 2, 2008) (CSS) (rollup of prepetition facility); *Circuit City Stores Inc.*, No. 08-35653 (Bankr. E.D. Va. filed Nov. 10, 2008) (KRH) (rollup of prepetition debt and priming liens on all property); *In re Pilgrims Pride Corp.*, No. 08-45664 (Bankr. N.D. Tex. filed Dec. 30, 2008) (DML) (prepetition and post-petition loans borrowing base and priming lien on all post-petition property); and, *In re Lyondell Chemical Company*, No. 09-10023 (Bankr. S.D.N.Y. filed Jan. 8, 2009) (REG) (priming lien on all assets of debtor).

Delaware during calendar year 2008 revealed a striking trend of allowing provisions that would have been unthinkable in previous years.¹¹

D. Applicability of the Business Judgment Standard.

Once a court determines that debtor-in-possession financing is only available under Section 364(c) of the Bankruptcy Code,¹² a key feature that courts examine is whether the debtor negotiated the DIP agreement at arm's length, and pursuant to its business judgment. Provided that this business judgment does not run afoul of the provisions and policies underlying the Bankruptcy Code, courts routinely grant a debtor considerable deference to approve a request for DIP financing in accordance with its business judgment.¹³ Finally, courts sometimes utilize its plenary powers under Section 105(a) of the Code to approve DIP financing requests where equity demands such a result.¹⁴

¹¹ Stratton, *supra*, note 2 at 32.

¹² Under Section 364(a), a debtor may obtain unsecured credit and incur unsecured debt in the ordinary course of business and the lender will receive a first priority administrative claim all without notice or hearing. Whether such borrowings are, in fact, in the "ordinary course of the debtor's business" implicates the usual considerations and anxieties about whether ordinary course under Sections 1107 and 1108 of the Code protect the lender. *See, e.g., Amdura Nat'l Distributing Company v. Amdura Corp. (In re Amdura Corp.)*, 75 F.3d 1447, 1453 (10th Cir. 1996); *In re World Access, Inc.*, 301 B.R. 217, 271 (Bankr. N.D. Ill. 2003) (held that constructive trust did not exist for the benefit of unsecured creditors when debtor, as part of routine procedure, conducted cash outflows and inflows with another company as part of a prior (years prior to bankruptcy) business arrangement). This outline will, however, focus exclusively on the more difficult and common issues in DIP financing where credit is sought under Subsections (c) and (d) of Section 364.

¹³ *See, e.g., Brav v. Shenandoah Fed. Sav. & Loan Ass'n (In re Snowshoe Company)*, 789 F.2d 1085, 1088 (4th Cir. 1986) (approving debtor-in-possession financing necessary to sustain a seasonal business); *Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683 (Bankr. E.D.N.C. 2009) (upholding debtor in possession financing standards while disapproving financing due existing lienholder's inadequate protection of security interest); *In re Ames Dept. Stores*, 115 B.R. 34, 37-40 (S.D.N.Y. 1990) ("cases consistently reflect that the court's discretion under Section 364 is to be utilized on grounds that permit reasonable business judgment to be exercised so long as the financing agreement does not contain terms that leverage the bankruptcy process in powers or its purpose is not so much to the benefit of the estate as to the benefit of the parties-in-interest"); *In re General Growth Properties, Inc.*, 423 B.R. 716, 725 (Bankr. S.D.N.Y. Feb 16, 2010) ("In determining whether to approve such a transaction, the Court acts in its informed discretion.") (quoting *In re Ames Dept. Stores* 115 B.R. at 37).

¹⁴ Section 105(a) of the Bankruptcy Code provides: The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party-in-interest shall be construed to preclude the court from, *sua sponte*, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

V. SUBSTANTIVE PROVISIONS OF SECTION 364, DIP FINANCING PROCEDURES, AND EVIDENCE REQUIRED UNDER THE BANKRUPTCY RULES

A. Overview of Section 364.

Section 364, which is among the shortest provisions of the current Bankruptcy Code, is an innovative creature of the Bankruptcy Reform Act of 1978. It is structured as a “waterfall” of rights that a lender may obtain and a debtor may request, depending upon what types of financing are available to the debtor, or not, in the financing marketplace.

The first tier of Section 364, Subsection (a), authorizes the trustee or debtor-in-possession (even in a Chapter 7 or a Chapter 9 case) to obtain unsecured credit and incur unsecured debt in the ordinary course of business, affording the creditor a first priority administrative claim without the need for court approval. If that type of credit is unavailable to a debtor, which is usually the case in the current economy, then the analysis shifts down the waterfall to Subparagraph (b), which allows the debtor, after notice and a hearing, to obtain unsecured credit or to incur unsecured debt other than under Subsection (a) which is then allowable under Section 503(b)(1) as an administrative expense.¹⁵

If the debtor is unable to obtain ordinary course unsecured credit or unsecured credit with an administrative priority, Section 364(c) then ratchets up to the level of the DIP facility to secured debt without employing forced priming or other reprioritization of existing liens on collateral.

Section 364(c), the provision under which most DIP financing is sought, provides:

(c) If the trustee is unable to obtain unsecured credit allowable under Section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt --

¹⁵ Section 503(b)(1) provides the administrative priority for the “actual, necessary costs and expenses of preserving the estate.” This administrative priority is subordinate to claims under Section 502(f) which involve “gap” claims in an involuntary case under Section 303. The priority provided under Section 364(b) begs the question, of course, of whether the debtor can obtain post-petition credit on an unsecured basis regardless of whatever payment priorities may be afforded to it.

(1) With a priority over any or all administrative expenses of the kind specified in Section 503(b) or 507(b) of this title;¹⁶

(2) Secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) Secured by a junior lien on property of the estate that is subject to a lien. (emphasis added).

The three financing alternatives listed under Section 364(c) are in the disjunctive.¹⁷

Consequently, the alternatives stated in Section 364(c) are not exclusive. The debtor may offer more than one of, or all of, those protections. If a lender extends credit only under Section 364(c)(2), however, and the collateral proves insufficient, courts have held that the creditor cannot fall back on Section 364(c)(1) automatically to claim a super priority over administrative expense claimants. Many, if not most, DIP agreements provide for all three rights and remedies of Section 364(c)(1)-(3).

It is important to note when obtaining credit (or granting credit) under Section 364(c), the priority over administrative expenses normally must be limited to the amount of the credit extended in order to adequately protect other priority claimants, and the borrowing remains subordinate to

¹⁶ Section 503(b) provides administrative priority for (a) the actual, necessary costs and expenses of preserving the estate including wages, salaries, commissions and benefits; (b) taxes incurred by the estate except for those specified in 507(a)(8) and certain other taxes; (c) significantly, compensation and reimbursement awarded under Section 330(a) (compensation of officers); (d) compensation to an indenture trustee; (e) allowed nonresidential real property lease rejection damages; and, (f) administrative priority for the value of goods delivered to the debtor within 20 days of the commencement of the case. Section 507(b) provides an administrative priority for unpaid adequate protection offered to a creditor under Sections 362, 363 or 364 (generally in the context of resisting a motion for relief from stay, or use of cash collateral).

¹⁷ The priority over all other administrative expenses provided by Section 364(c) is sometimes known as a “super priority” lien. Can this priority be upset if the case converts to a case under Chapter 7 because the expenses of a superseding Chapter 7 case will have priority over the expenses of administration of a superseded Chapter 11 case under Section 726(b)? The DIP financier who obtains a super priority lien above the Section 507(b) priority is protected from that outcome in a converted case because Section 507(b) priority includes priority over the expenses of a superseding liquidation otherwise provided by Section 726(b) (however, not over priority status granted to another extender of credit under Section 364(c)(1)).

(i) pre-existing secured claims, and (ii) any efforts to surcharge secured lenders' collateral under Section 506(c), unless that right is waived.¹⁸

Holders of a first priority security interest on assets of the estate may object to imposition of Section 364(c)(3) junior liens on property for a number of procedural reasons, not the least of which is state law that may require extraordinary notice to junior lienholders in the event of foreclosure and repossession by the prior senior lienholder. The court may grant junior liens on encumbered assets, or liens on unencumbered assets, however, notwithstanding a restriction on the granting of such liens contained in prepetition agreements between the debtor's other creditors.

If the debtor is unable to obtain credit under Subsections (a), (b) or (c) of Section 364 (for example, with respect to subsection (c), where there are insufficient unencumbered assets (or property subject to existing liens lacks any equity above those liens) or the case has a substantial risk of being administratively insolvent), then Section 364 ratchets up to the next level of pain for non-lender creditors by allowing existing liens to be primed in favor of the DIP lender.

Section 364(d) provides:

(1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on the property of the estate that is [already] subject to a lien only if –

(A) The trustee is unable to obtain such credit otherwise; and

(B) There is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

¹⁸ See *In re Debbie Reynolds Hotel and Casino, Inc.*, 255 F.3d 1061 (9th Cir. 2001). Section 506(c) allows a creditor's collateral, whether the lien is obtained prepetition or post-petition, to be surcharged for "the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property." As discussed under Section VIII below, DIP lenders, whether granting credit under authority of subsections (c) or (d) of Section 364, often require Section 506(c) waivers. Also, DIP lenders often request, when obtaining the protections of all three subsections of Section 364(c), waiver of requirements to "marshal" assets if there is a default and enforcement against collateral is undertaken.

In any hearing under subsection (d), the debtor has the burden of proof on the issue of adequate protection.¹⁹

B. Preliminary Showings Required for Relief.

A debtor, in climbing up the ranks of remedies provided by Section 364(a)-(d), must show that it has made acceptable efforts to find credit on less severe terms than requested under the subsection of Section 364 that it invokes. The debtor is not under a duty, however, to seek credit from every possible lender in that process.²⁰ The priming liens of Section 364(d) can be granted notwithstanding any restrictions in the prepetition lending or lien documents between the debtor and the affected secured creditor to the contrary.

The requirement to furnish adequate protection to the primed secured creditor, as defined by Section 361 and case law, raises the same thorny issues as it raises in the stay relief, use of cash collateral, or any other setting in which adequate protection must be furnished. One method of furnishing adequate protection under a Section 364(d) scenario, as defined by Section 361, is the debtor providing lump sum or periodic cash payments to the affected secured creditor. Adequate protection is, as it is in other settings, measured by the value of the collateral supporting the secured claim as of the filing of the petition, and is “always determined by the extent of the anticipated or actual decrease in the value of the secured creditor’s collateral during the bankruptcy case.”²¹ An effective method of demonstrating adequate protection when invoking Section 364(d) relief is to present evidence that the post-petition financing facility will allow debtor to generate sufficient cash

¹⁹ Bankruptcy Code § 364(d)(2).

²⁰ See *Bray v. Ingersol-Rand Financial Credit Corp. (In re Snowshoe Company, Inc.)*, 789 F.2d 1085, 1088 (4th Cir. 1986); *Suntrust Bank v. Den-Mark Const., Inc.*, 406 B.R. 683, 690-693 (Bankr. E.D.N.C. 2009).

²¹ See *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 564 (3rd Cir. 1994); *In re O’Connor*, 808 F.2d 1393, 1396-97 (10th Cir. 1987). See generally *Marcus Lee Associates, L.P. v. Wachovia Bank, N.A.*, NO. CIV. A. 10-667, 2011 WL 206126 (E.D. Pa. Jan 20, 2011). Adequate protection does not include compensation for lost opportunity cost. *United Savings Ass’n of Texas v. Timbers of Inwood Forest Associates Limited*, 484 U.S. 365, 374-75 (1988); *In re SW Boston Hotel Venture LLC*, No. 10-14535-JNF, 2011 WL 309060 (Bankr. D. Mass. Jan 28, 2011).

flow to make periodic cash payments to the primed creditor. In this circumstance, approving a DIP facility with priming liens is the horse, and the ability to pay adequate protection in the form of periodic cash payments is the cart.²²

VI. PROCEDURE AND EVIDENCE FOR APPROVAL OF DIP FINANCING UNDER SECTION 364(b)-(d)

All post-petition financing, except ordinary course unsecured credit under Subsection (a), requires court approval.

A. The Requirements of the Motion and Notice.

A court can only approve a post-petition financing facility after “notice and a hearing” if approval is sought under subsections (b) through (d) of Section 364.

A motion to approve post-petition financing is a contested proceeding, rather than an adversary proceeding, and is therefore governed by the provisions of Bankruptcy Rule 9014 rather than Bankruptcy Rules 7001, *et seq.* Most important, the proceedings for approval are specifically governed by Bankruptcy Rule 4001(c). Partially for sake of clarity and transparency to the DIP financing approval process, Rule 4001(c) was amended in December 2007. The amended rule now requires that a motion requesting approval of a DIP financing agreement contain a concise statement of, among other things, the location within the agreement of all material provisions of the proposed agreement including interest rate, maturity, events of default, liens, borrowing limits and conditions. This statement must also address the grant of priority, provision of adequate protection and any waiver or modification of the Code provision relating to the automatic stay.²³

Consequently, any motion for approval of DIP financing must contain, ideally in a separate and

²² Other arguments include that the collateral is actually appreciating, that the value has been increased by the filing of the case and the obtaining of financing, etc.

²³ Most jurisdictions have a variation of Rule 4001(c) in their local rules, some of which require more detailed itemization of DIP financing terms than required by Rule 4001(c). Consequently, it is essential to consult and comply with the local rules of the court when the case is filed.

clearly organized section, all of the disclosures required by Rule 4001(c) as well as those required by local rule in excess of Rule 4001(c). Thus, if the DIP facility contains such provisions, the motion must disclose:

1. The grant of priority or lien on property under Subsections (c) or (d);
2. The provision of adequate protection or priority for a claim that arose before the commencement of the case or other adequate protection offered to a non-lender secured creditor;
3. Whether the agreement requires determination of the validity, enforceability, priority or amount of a claim or a lien securing the claim;
4. Whether the agreement requires a waiver or modification of the automatic stay;
5. Whether the agreement requires a waiver or modification of authority to file a plan, to seek to extend exclusivity, to request of use cash collateral, or obtain credit from other lenders under Section 364;
6. Whether the agreement requires establishes deadlines for filing a plan or approval of a disclosure statement;
7. Whether the agreement requires a waiver or modification of non-bankruptcy law relating to perfection of a lien on property of the estate or on foreclosure;
8. Whether the agreement requires a release, waiver or limitation of any claim or other cause of action belonging to the estate or the trustee;
9. Whether the agreement requires an indemnification for the DIP lender;
10. Whether the agreement requires a release, waiver or limitation of any right under Section 506(c); and
11. Whether the agreement requires the granting of a lien on a claim or cause of action arising under Sections 544, 545, 547, 548, 549, 553(b), 723(a) or 724(a).

Service of the DIP motion must be made on the Committee of Unsecured Creditors, if there is one, or if there is not yet a committee, on all creditors included on the list of creditors filed under Rule 1007(d); and, (2) on any other entity that the court directs. The best practice is to serve the motion as widely as possible, particularly on anyone who requests service. Serving all known creditors will resolve any claims of lack of reasonable notice. A trap for the unwary is that Rule 9034 requires that the motion be served upon the United States Trustee, because it is not provided in the service provisions of Rule 4001(c). This obligation to serve notice on the United States Trustee is consonant with the statutory duty of the United States Trustee to monitor Chapter 11 cases under 28 U.S.C. § 586.

As noted above, many DIP financing applications happen on an emergency, or “first day,” basis. Bankruptcy Rule 4001(c) provides that a final hearing on a motion to obtain credit pursuant to Section 364 may not be commenced earlier than fourteen (14) days after the service of such motion. The oft-invoked exception to this notice requirement to accommodate emergency hearings is found in Rule 4001(c)(2), which provides that “if the motion so requests, the court may conduct a hearing before such 14-day period expires, but the court may authorize the obtaining of credit only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.”

An interim financing order, entered on shortened notice, normally does, and should, closely resemble the form of final financing order that the lender desires and that the debtor is willing to give. Non-lending creditors and parties in interest need to be aware that the theme and content of the interim order will likely have a profound effect on the ultimate form of final order. Nevertheless, interim orders are just that, interim, and the court can alter interim orders as it sees fit. It is essential for parties to participate in the interim application, however, simply because the interim order terms frequently carry into the final order.

B. Presentation of Evidence to Support the Motion.

The quantum of evidence that must and should be presented at a DIP financing hearing, whether an emergency interim hearing or a final hearing, is suggested by the elements and burdens of proof described in Section 364 itself. Section 364, in its cascading structure, requires the debtor to show that it was unable to get financing from anyone else or on any better terms. To conduct a hearing sooner than 14 days under Rule 4001(c)(2), the debtor must show immediate and irreparable harm if the financing is not granted.

The debtor need not show that it sought credit from every possible lender,²⁴ but the debtor must testify as to efforts it did undertake to find a better deal. The simplest way to provide the evidence, as a practical matter, is to put debtor's CEO or CFO on the witness stand and simply have them testify as to the nature of the business, the factors leading it into Chapter 11, the debtor's attempts to find money from other lenders, the negotiations with the proposed DIP lender, the aspects of the debtor's business concerning acute and daily needs for cash and credit (including wages, supplies, fuel, inventory, etc.) and testimony that if there is any delay in the credit arrangements, the debtor's business will collapse. Some testimony, although not exhaustive, regarding the liquidation value of the debtor, as opposed to its value as a going concern, is desirable. Some courts will allow this testimony to be presented by proffer or declaration, but subject to live cross-examination of the declarant should any party-in-interest desire it.

VII. THE APPELLATE SAFE HARBOR OF SECTION 364(E)

One concern for lenders is that if they obtain an emergency order providing DIP financing to a debtor on terms that were actively contested, and they lend money to the debtor under the DIP order, that the DIP order might be reversed on appeal. This would impair or nullify the DIP

²⁴ *Bray v. Ingersol Rand Financial Corp.*, 789 F.2d 1085 (C.A. 4 (W.Va.) 1986).

lender's ability to be repaid, the priority of their post-petition liens, and other relief and protections given in the DIP order. As is the case with Section 363(m), Section 364 recognizes that post-petition lending, like a sale of assets, often must be implemented and performed before an appeal can be taken, let alone heard, placing the lender at risk. In short, there is usually no way to "put the toothpaste back in the tube" if a financing order is reversed on appeal. An important protection of Section 364, that should be the subject of a specific finding in any interim or final order is subsection (e). Section 364(e) is very similar to Section 363(m), and provides:

The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to any entity that extended such credit in good faith whether or not such entity knew of a pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal. (emphasis added).²⁵

The touchstone of Section 364(e) mootness protection is "good faith."²⁶ Again, for the lender to have the benefit of 364(e), there must be an express finding that the financing was negotiated in good faith.²⁷ "Good faith" fundamentally speaks to the integrity of the parties' conduct during the course of the proceeding.²⁸

²⁵ 11 U.S.C. § 364(e). Compare Section 364(e) with 363(m), which provide, respectively, that appeals of financing orders and asset sales are moot if the financing or the sale were undertaken in good faith. In order to avoid mootness on appeal, a stay pending the appeal must be obtained under Bankruptcy Rule 8005. Such stays are extremely difficult to obtain.

²⁶ See, e.g., *Weinstein, Eisen and Weiss, LLP v. Gill (In re Cooper Commons LLC)*, 430 F.3d 1215 (9th Cir. 2005), *cert. denied*, 126 S. Ct. 1340 (2006); *In re Foreside Management Co., LLC*, 402 B.R. 446, 450 (1st Cir. BAP 2009).

²⁷ *In re Revco D.S. Inc.*, 901 F.2d 1359 (6th Cir. 1990) (an implicit finding of good faith is insufficient under Section 364(e); good faith should not be presumed and must be expressly found) *But see Distinguished by In re Foreside Management Co., LLC*, 402 B.R. 446, 451 (1st Cir. BAP 2009) (court elected not to be confined by good faith "expressly found" standard).

²⁸ *Community Thrift and Loan v. Suchy (In re Suchy)*, 786 F.2d 900, 902 (9th Cir. 1985) (citing *Prichard v. Sherwood & Roberts, Inc. (In re Kings Inn, Ltd.)*, 37 B.R. 239, 243 (Bankr. 9th Cir. 1984)); *See also In re M Capital Corp.*, 290 B.R. 743, (9th Cir. BAP 2003).

VIII. FROM THE MUNDANE TO THE SHOCKING: SPECIFIC PROVISIONS OF DIP FINANCING AGREEMENTS AND APPROVAL ORDERS

The battleground in obtaining approval of DIP financing agreements is the array of specific provisions that are routinely found in DIP lending documents that are peculiar to, and often contested or frowned upon, in the bankruptcy setting. While the list discussed below is by no means exclusive, nor does it purport to address the unlimited bounds of creative thinking employed by transactional lending lawyers, the non-traditional lending industry, and desperate debtors, it nevertheless affords a flavor for some of the drafting techniques that are used in DIP loan agreements and whether those techniques will be approved when presented to a court and skeptical parties-in-interest.

A. 13-Week Cash Flow and Budget.

DIP financing should be made only under a well itemized and approved budget that is updated at regular intervals during the post-petition, pre-confirmation period in the case. The author strongly recommends requiring a 13-week rolling cash flow and budget (i.e., that the budget is a 13-week projection and budget at any time in the case). The 13-week budget creates focus and accountability, two things that are normally lacking in a corporation in financial trouble. The benefits of requiring a 13-week cash flow are well summarized in a recent article, Robert D. Katz, “13-Week Cash Flow: The Difference Between Success and Failure,” *Dow Jones Daily Bankruptcy Review*, November 17, 2010 at 13.

B. Rollover Provisions.

The prepetition secured lender that agrees to provide DIP financing will benefit from rollover of prepetition secured debt into DIP financing. This provision is consistent with situations where the post-petition financing resembles a continuance of the prepetition facility. This is accomplished either as a single advance under the DIP loan or through, for example, the application of post-petition collections of receivables being applied to the prepetition loan with those advances

being made under the DIP facility. This provision should provide, among other things, that the terms of the prepetition facility stand in full force and effect, that the lender has a first priority lien on property generated post-petition (such as receivables) notwithstanding Section 552 of the Code, all to create an environment where there is a seamless continuation of the prepetition facility into the post-petition period, as amended in the DIP Agreement.

C. Agreements to the Amount and Perfection of the Lender's Liens.

It is common practice for debtors to stipulate at the outset of the case to the extent, validity and priority of the prepetition lender's liens, subject to the right of a Committee or other parties in interest to challenge that stipulation. The establishment of and validity and perfection and extent of the post-petition liens are, of course, provided by the DIP financing order.

D. Provision for a Committee Investigation.

A common point of contention is providing for a period of time under which a Committee will have the opportunity to challenge the validity, priority and extent of a lender's prepetition liens and a borrower's potential claims against the lender. This issue is a corollary to the common lender request that the debtor stipulate to the nature, extent, amount and priority of the lender's liens and claims and waive any and all claims against the lender as a condition of financing. Official Committees have a duty to investigate such things. Without a provision that specifically authorizes time for a Committee investigation, Courts, U.S. Trustees and unsecured creditors fear that stipulations regarding privity and waivers of the debtor's claims will bar any post-petition investigation and action by the Committee or the Trustee should they discover grounds to challenge the lender. This debate often occurs during emergency motions for DIP financing, where the U.S. Trustee has not had an opportunity to appoint a Committee, and before it is known whether a Committee will even form. Generally, in an emergency situation, U.S. Trustees will push for a Committee investigation exception to the waivers and stipulations as a requirement of entry of the

interim emergency order. The provision should provide that a Committee has a particular period of time in which to investigate and bring actions against the lender lest such claims be barred. It is rational for a lender to want to have some certainty as to its lien positions. The requested investigation period is generally between 60 and 90 days from the date the Committee is formed. Delaware Local Rule 4001-2(a)(i)(B) provides that the debtor must provide justification to the court with respect to any request that the Committee's investigation period be less than 60 days from the date of the formation of the Committee.²⁹

E. Allocation of Fees to a Committee for Investigation of Liens.

Generally a DIP lender will have a first lien on all cash, as well as post-petition cash and receivables, and superpriority liens on all assets. Although the DIP lender may give a Committee a period of time to investigate actions against the DIP lender, the DIP lender normally will not want to pay for the Committee to conduct its investigation. The problem, of course, is that the Committee's fees come from the estate, and if the debtor's assets are completely lien-ed up by the lender, there will be no money to pay the Committee. Generally, courts require a carve out from the lender's collateral to pay for the committee to *investigate* liens, but the DIP lender often prevails against requests for a carve out to fund Committee efforts to actually bring actions against the lender. As a general rule, some carve out for the Committee's investigative fees is necessary for the DIP Agreement to pass muster with the court and the U.S. Trustee.³⁰

²⁹ Sometimes the request is made from the investigation period to run from the date of selection of committee counsel rather than the formation of the committee.

³⁰ The additional question is whether provisions can be placed in the DIP order barring entities other than the official committee from attacking the lender's prepetition position. It can be argued that the committee has that responsibility. Some DIP facilities provide that parties other than the committee, who are generally served with the DIP motions, even when filed as emergency motions, have a substantially shorter period of time, if given an exception from the waiver, than a committee to investigate such liens. As to all of these kinds of provisions, including investigative periods of committees and carve outs, the lender always has the option, if it uncomfortable, of simply walking away from the DIP financing negotiating table.

F. Releases of the Prepetition and DIP Lender.

DIP Lenders generally request waivers in the DIP order resolving any issues arising from the lending relationship, whether prepetition, post-petition, or both. As noted above, the alert lender should always ask for waiver of any challenge to the validity, priority and extent of the lender's lien from the debtor. The lender may also want a waiver or release of any potential lender liability or, for that matter, Chapter 5 avoidance actions have, although those avoidance actions could be preserved for the Committee. DIP orders have for some time, however, had a practical effect of barring claims by the debtor against their prepetition lender.

G. General Carve Outs for Fees of the Debtor's Counsel, U.S. Trustee Fees, and the Debtor's Other Professionals.

Again, most DIP facilities will provide a lien on virtually all assets of the estate, including all cash, whether in existence as of the petition date or generated thereafter, notwithstanding Section 552. As a general rule, cash collateral may not be used to pay administrative expenses. Thus, under most DIP facilities, the estate finds itself unable to find a source to pay fees of debtor's counsel, non-investigative fees of the Committee, fees of debtor's other professionals (such as accountants, advisors and otherwise), United States Trustees fees and other administrative expenses. Absent consent by the lender, all of those expenses are lower in priority than the DIP lender's secured and superpriority claims, in addition to the prepetition secured debt.

Lenders and debtors should give careful consideration to an appropriate carve out from those liens to pay post-petition fees. A DIP lender often wants the debtor to continue as a going concern, and realizes that those expenses must be paid. The appropriate amount is very difficult to estimate, and will be determined by the size and complexity of the case. The lender should also carefully provide in the carve out that the carve out is not, contrary to the belief of many debtors and debtors' professionals, a carte blanche commitment by the lender to write a check to professionals if the estate is administratively insolvent. A carve out is just that, an agreed exception to the lender's lien

on estate cash. It is not a commitment to pay new money from some source (usually the lender) other than estate assets.³¹ The lender should also provide that the carve out applies only to the debtor's Chapter 11 expenses, and not to Chapter 7 expenses, including expenses of a Chapter 7 Trustee, in the event of conversion.³²

H. Provisions for Liens by the Lender on Avoidance Actions.

Ideally, a lender will want a lien on avoidance actions brought against itself.³³

I. Extension of Superpriority Claims Under Section 507(b) to Avoidance Actions.

Lenders will want to provide, often over Committee objections, that the DIP lender can assert a superpriority claim under Section 507(b) that extends to, or more particularly would be paid from, recoveries on avoidance actions. Interesting compromises have been struck on the request for such provisions, such as limiting the superpriority claim to recoveries for post-petition transfers under Section 549.

J. Waivers of Section 506(c) Remedies.

Section 506(c) permits the estate to "surcharge" a secured creditor's collateral for administrative claims that the estate has incurred in preserving or disposing of the collateral to the benefit of the secured creditor. These kinds of claims can, potentially, be significant, and have the

³¹ For this reason, the lender should require, and the debtor should provide, line items for professional fees and U.S. Trustee fees in the 13-week budget and not view the carve out or the obligation to pay debtor professionals as extra-budgetary or extraordinary items.

³² A provision in a DIP Agreement providing that the carve out applied only to Chapter 11 fees and not to Chapter 7 fees was litigated between a Chapter 7 trustee, upon conversion, and the author's client *In re JLT Enterprises Inc.*, No. 10-40129 (Bank. N.D. Ga. filed January 13, 2010) (Judge Deal). The issue was resolved in favor of the lender and against the Chapter 7 trustee based on provisions of the DIP Agreement. A copy of the court's decision and order is appended hereto as Appendix C.

³³ Even if the lender does not obtain waivers of potential avoidance actions against it by the debtor or committees, if it obtains a lien on the avoidance actions, such lien has the practical effect of giving the lender the benefit of any recovery against itself if it is undersecured. Committees and U.S. Trustees will often object to such liens, but they are obtained by lenders in many cases. Sometimes these liens can be obtained through compromising by taking a lien on avoidance actions in favor of the lender only to the extent that the post-petition liens and adequate protection liens are not satisfied by payment either from the debtors or application of the proceeds of collateral. *See, e.g., In Re Tropicana Entertainment LLC*, No. 08-10856 (Bankr. D. Del. filed May 5, 2008).

practical effect of priming the DIP lender's liens. Thus, the DIP lender will want a waiver of those claims from the debtor in the DIP Agreement. A corollary to this waiver is waiver of the marshalling or any other similar doctrine with respect to multiple items of collateral should the lender need to foreclose. Section 506(c) waivers are very common.

K. Contractual Cross-Payment Provisions.

The DIP lender, who is often the debtor's prepetition lender, should normally be entitled to preferred treatment over other secured creditors who decide not to take the risk of lending to the debtor. Frequently, lenders have multiple prepetition facilities with the debtor that they effectively convert into the DIP facility. These multiple facilities can often be divided into two categories, those being operating lines of credit which provide cash against receivables or some other borrowing base, on the one hand, and typical secured debt such as promissory notes secured by real estate, equipment, or other personal property. With that structure, most lenders have a control account where monies advanced on the credit line are first deposited into a lender account and then drawn down into the debtor-in-possession account, whether the DIP account is held with the lender or not. The DIP lender in this situation can, and often does, provide in the DIP Agreement that it is entitled to take full contractual payments on its secured facilities during the post-petition period of the case, whether or not other similarly situated secured creditors are receiving their full contractual payments, whether through adequate protection arrangements or otherwise. These full payments should be carefully budgeted by the debtor in the 13-week budget so that all creditors can see the effect on cash flow. Many similarly situated creditors will object that the provision is "discriminatory," but the DIP lender simply needs to take the position that it will not advance the DIP facility unless it has the ability to receive these payments. These provisions should include the payment of the DIP lender's attorneys' fees, including those incurred prepetition and those involved in the DIP financing transaction.

L. Payment of the Lender's Attorneys' Fees as an Ordinary Course Expense.

Lenders normally involve counsel at all stages of the DIP financing process, as well as representing the creditor in the case generally. Lenders and their counsel will be extensively involved in the DIP negotiations, in assisting the debtor in documenting the DIP facility, and in getting the orders entered that are necessary to approve the DIP. Frequently, experienced lenders' counsel will provide debtors who are not accustomed to the DIP financing environment with agreements, forms of orders and other custom drafted documents and pleadings. All of this drafting will cause the DIP lender to incur expense. These attorneys' fees directly benefit the debtor, in that they facilitate the negotiation, documentation, and approval of the DIP facility.

The DIP lender will often provide that its attorneys' fees are payable from the estate. The source for payment is cash generated by the debtor from operations or under lines of credit. A draw schedule should be agreed to between debtor and the DIP lender because if the lender incurs significant attorneys' fees in participating in the DIP financing process which it cannot recover, it is essentially lending the debtor more money without provision for repayment of the advance. These provisions for payment of the lenders' attorneys' fees without court approval are tenable under the Code because the lender's counsel is not an estate or committee professional under Sections 327, 328 and 330 of the Bankruptcy Code. Such provisions are often approved, but lenders sometimes agree to submit bills to debtor's counsel that the debtor can bring before the court for determination of "reasonableness."

M. Waiver of Claims Under Section 553(b).

As a corollary to waiver of claims under Section 506(c), the DIP lender often seeks waiver of claims under Section 553(b) of the Code.³⁴

N. Stay Relief Without Application to the Court.

A DIP lender, given the risk inherent in DIP financing, will want provisions providing for self-executing relief from the automatic stay to exercise rights against collateral in the event of default under the DIP Agreement, which should also incorporate the prepetition agreements where the DIP lender is also the prepetition lender. The question in negotiating stay waivers is always one of execution of the waiver. In the DIP lender's ideal world, the DIP lender simply finds an event of default or other triggering event and acts on its collateral without any notice or other entanglements. More frequently, however, the DIP lender is asked to do one of the following: (i) file a declaration describing the triggering event, with service on interested parties as negotiated; (ii) in addition to the declaration, afford the debtor, the U.S. Trustee, or other parties in interest the right to cure the triggering event, although the length of the cure period is often the subject of intense debate; (iii) furnish the court with a proposed order, along with the declaration, to secure the relief. With respect to notices of the DIP lender's exercise of the right to stay relief, the extent to which the DIP lender must give notice, and to whom, is often hotly debated.

O. Indemnification of the Lender.

A DIP lender often requests that the debtor indemnify the DIP lender from any claims arising out of the DIP Agreement, the transactions contemplated in the DIP Agreement, or the use of proceeds. The DIP lender may also request indemnification for any action brought against the DIP lender arising out of the bankruptcy case. This is often a means through which the DIP lender

³⁴ Section 553(b) of the Code fundamentally provides for an avoidance claim which can be brought against a creditor for any insufficiency, calculated by a set off exercised by the creditor against the debtor within 90 days of the petition, that exceeds a mutual debt owing to the debtor by the holder of the claim. Section 553(c) contains the same presumption of insolvency of the debtor within 90 days of the petition date contained in Section 547.

can protect themselves from avoidance actions, particularly those brought under Section 549, even if they are unable to obtain broad waivers of avoidance actions by all parties, let alone the lender. For example, if the DIP lender pays an avoidance judgment or settles an avoidance claim in its discretion, the DIP lender may provide that the debtor needs to indemnify the DIP lender from that payment which, as a practical matter, means adding it on to the DIP loan facility and providing for its repayment. This is a corollary to the listing of events of default, where one event of default is the occurrence of a successful avoidance claim against the DIP lender under Sections 547, 548, 549, or 553(b) of the Code.

P. General Cross-Collateralization.

While some case authority militates against cross-collateralization in the true sense, (i.e., cross collateralizing prepetition debt with post-petition assets,³⁵ cross collateralization may arise in different ways. For example, frequently a prepetition lender who becomes a DIP lender will incorporate into the DIP facility several secured loans that are individually secured by identifiable collateral, but are not cross collateralized such that the entire basket of collateral secures all of the loans. For example, if the DIP lender has a note secured by real estate, and another secured by equipment, but the prepetition documents do not cross collateralize those notes, the DIP facility may do so. This circumstance does not appear to conflict with the ruling in *Saybrook*, because the lender already holds a lien on the collateral in the individual notes that are simply being incorporated into the DIP facility, and continuing according to the original loan terms, rather than being called or simply treated as a contested secured claim. While this is a method of improving the lender's position, there is really very little prejudice to the estate, as the lender already holds senior

³⁵ See *Shapiro v. Saybrook Manufacturing Company, Inc.*, 963 F.2d 1490, 1494-5 (11th Cir. 1992)

liens on the collateral. It is also reasonable because very often collateral values will deteriorate simply because of the filing of the case.³⁶

Q. Guarantor Acknowledgements.

The DIP Agreement and Order should provide that, if the DIP lender is also a prepetition lender, the prepetition Guarantors of either the DIP facility, or the prepetition facility, will reaffirm their guaranties, and agree that the DIP financing is not, in any way, a material variation of the Guarantors' exposure to the debtor's underlying obligation. As such, the Guarantors waive any objections to guaranteeing claims in favor of the lender that arise during the case under the provisions of the DIP facility. The Guarantors execute the DIP loan documents as separate, signatory guarantors of the DIP facility, as well as reaffirming their prepetition obligations and providing standard waivers of rights that guarantors might otherwise have at common law.³⁷

R. Installation of Financial or Managerial Professionals at Estate Expense.

A DIP agreement, particularly in medium-size cases where management has struggled to keep the debtor viable, should provide a provision that allows the DIP lender to install at the debtor's headquarters, or primary facility, a financial professional with full access to the debtor's books, records, customers, or employees. This provision should allow the installation of a turnaround CEO who can come in, sometimes under a defined set of circumstances such as (i) the

³⁶ Significantly, the Seventh Circuit held that the Bankruptcy Court has equitable powers under Section 105 of the Code to grant cross collateralization (or other equitable relief) in circumstances where the debtor can prove that "but for" the grant of the cross collateralization relief, the debtor would cease its business and that the benefits to the creditors may be affected by such extraordinary relief outweighs the harm or at least leaves them no worse off. *In Re K-Mart Corp.*, 359 F.3d, 866 (7th Cir. 2004).

³⁷ Guarantors of the debtor's prepetition facilities are often principals whose personal finances become highly stressed by the debtor's financial misfortunes. It is not uncommon for guarantors who are principals of the debtor to file personal Chapter 11 or Chapter 7 petitions. The DIP Agreement should provide that discharge of the guaranty is an event of default under the DIP facility. This is reasonable because if the guaranty is discharged, the key underwriting aspect of the loan, the presence of guarantors, is altered. As a practical matter, the guarantors should be required to reaffirm their guaranties in their individual cases, and the guarantor provisions of the DIP Agreement may provide for just that remedy. Often, the individual debtors will not want to reaffirm their guaranties unless and until the principal debtor emerges from Chapter 11. Particularly in Chapter 7 cases, securing a reaffirmation may require the debtor in their individual case to move to extend their discharge in order to accommodate the timing of the principal business debtor emerging from bankruptcy. Of course, reaffirmations must be secured before discharge.

filing of a motion to appoint a trustee or dismiss, (ii) discovery of fraud or gross mismanagement, or (iii) a deterioration in cash flow or operations under certain defined metrics. The DIP agreement can provide that the turnaround or financial professional is installed without the need for court approval, and is paid from the estate. This is a powerful provision if the lender is a working capital or credit line provider, and maintains a control account over the advances.

Debtors will often request, and the lender should consider, a cap on the total amount of fees to be paid to professionals. Regardless of the cap on fees, be it low or high, this can be a significant provision for a lender, and it can also be accompanied by waivers of claims that the debtor may assert against the lender for exerting improper control, whether arising in the past or occurring prospectively. The agreement may simply provide that in the event of installation, the debtor waives any claims of over control.³⁸

This provision is much more advantageous than moving to appoint a trustee. First, it is automatically triggered on the occurrence of certain events. Second, the lender can appoint someone it can work with or it wants in control, whereas a trustee that is appointed as a result of a Motion to Appoint a Trustee may or may not be someone who is palatable to the lender.

S. Circumscribing Events of Default.

The recitation of events of default in a DIP facility is very important. Some lenders tend to rely on the types of events of default that are typically found in prepetition lending agreements. These standard default provisions are not enough, and events that are peculiar to the bankruptcy environment should be included. In addition to standard events of default, such as failure to make timely payments, failure to maintain and insure collateral, the following events of default, many of

³⁸ As a practical matter, when a lender reaches the point of wanting to install such a professional in the debtor's operations, there is concurrence by the committee and other key creditors who are affected by the events which would trigger the right to install this professional. Thus, a lender, if such right is reasonably exercised, will more often than not have the support of other constituencies in the case.

which are peculiar to the post-petition environment, should be included in DIP financing documents:

1. Failure to timely pay U.S. Trustee fees and file required monthly operating reports;
2. A grant of relief from the stay to other creditors that results in a diminution of estate assets of a particular kind, or over a certain amount in value;
3. Any violations of any material term of the orders approving the DIP financing;
4. The granting of a lien or other interest in any property of the debtor, or a superiority claim, by the court that is superior to, or ranks in parity with, the lien of the lender granted in the DIP facility and the DIP financing order, except as permitted under the financing order or given with the consent of the lender;
5. Where any lien purported to be created by the DIP facility and the approval orders cease to be a valid or perfected lien, or loses priority under Section 364(c) and (d);
6. Where any action is commenced by the debtor that contests the validity, perfection, or enforceability of any prepetition liens or any liens established by the DIP approval orders;
7. The Chapter 11 case is dismissed or converted to Chapter 7;
8. A trustee under Chapter 11 is appointed in the Chapter 11 case;³⁹
9. The court appoints an examiner, or any other person with augmented powers, relating to the operation of the business under Section 1106(b) of the Code;
10. The order approving the DIP facility is amended, reversed, stayed, vacated or modified in a manner that materially and adversely affects the rights of the DIP lender, and is not acceptable to the DIP lender;

³⁹ Some more aggressive DIP lending agreements provide that the mere filing of a Motion to Appoint a Trustee by any party in interest is an event of default, even before it is granted.

11. The debtor files an application for approval of any other superpriority claim in the Chapter 11 case that is *pari passu* with, or senior to, the claims of the DIP lender with respect to the obligations under the DIP facility, or there shall otherwise arise any such *pari passu* or superpriority claim;
12. The court fails to enter an order that makes an appropriate “lien finding” within the number of days allowed for investigation following the date of appointment of a Committee. A “lien finding” is a provision in the order that holds that the DIP lender’s prepetition liens are duly perfected and that the nature and extent of the liens are in accordance with the lender’s claims. The order may be drafted in a way that the lien finding arises automatically if the Committee or other party in interest does not file an action challenging the lien finding or the nature, extent or priority of the prepetition liens within the investigation period granted to the Committee;
13. In a case where the financing order is entered at the first of the case, and is initially authorized under an interim financing order, a failure by the Court to enter a final financing order within a set period of time after the case is commenced. Normally, this period of time is not more than 45 days;
14. The entry of an order under Section 363 of the Bankruptcy Code allowing the use of cash collateral in which the DIP lender has an interest, or allowing a sale, use, or lease other than the ordinary course of business of other property in which the DIP lender has security interest;
15. The entry of an order under Section 364(c) or (d) where the debtor obtains post-petition financing from another lender. Normally, the presence of multiple post-petition lenders, which are not syndicated with the original lender, can cause substantial confusion and risk to the original DIP lender. While this is the functional

equivalent of an exclusive lending right to the estate, the lender should be able to terminate its financing facility if the debtor brings in another lender. Normally, if the estate is sound and the original lender's underwriting criteria for the loan are not threatened, the new lender should be able to take the original lender out;

16. Filing of a competing plan by a creditor which the DIP lender does not approve;
17. Commencement of avoidance actions by any party against the DIP lender, either generally or if over a certain monetary amount.

T. Failure to Pay Post-Petition Accrued Taxes.

The temptation of cash-strapped debtors to use their employee trust fund deposits as a defacto bank is sometimes irresistible. It can also create large problems with the operation of the estate and, at minimum, is a key metric that indicates significant problems with the estate.

Likewise, the debtor should stay current on use and sales taxes and other such taxes in the ordinary course of its operations. If it is not doing so, this raises a red flag concerning the debtor's overall operations.

U. Setting Maturity Dates and Case Milestones.

Setting the maturity date of the DIP facility requires close attention to the overall dynamics of the estate, as well as the lending relationship. Frequently, DIP facilities provide for maturity on the termination of exclusivity under Chapter 11 of the Code, as originally occurring or as extended (i.e., a maximum of 180 days from the petition date). The DIP lender can always extend the maturity date by agreement with the debtor and the DIP facility should provide for the ability to agree to extensions without court approval or notice to other parties. Other case milestones include an event of default for failing to file a Plan and Disclosure Statement by a date certain, or, turning a stick into a carrot, providing for an automatic extension of the maturity of a set number of days or weeks upon the filing of a plan and disclosure statement. Other potential milestones that could

support an extension of the DIP facility may include an increase in the debtor's earnings or net income, or the elimination of certain nonprofitable functions and other specifics, although these kinds of milestones should be inherent in a well-managed Chapter 11 case. It is particularly important to have a termination provision of the DIP facility upon confirmation of a plan. Such a termination provision, which bookends the maturity date, allows the lender to evaluate the performance of the debtor under the facility during the post-petition, pre-conformation period of the case, and decide whether it wants to continue to extend credit to the debtor post-petition. In this way, the lender has an opportunity to negotiate an exit facility with the debtor that, although it may closely resemble the DIP facility, may include changed terms in accordance with the lender's experience with the debtor during the period post-petition and pre-confirmation.

V. Provision for Extraordinary Reporting.

Although debtors have an obligation to file monthly operating reports on the forms dictated by the U.S. Trustee, often those reports are not as thorough or formatted in a way that a lender would ideally like. DIP agreements frequently provide for reporting of financial results in a format, and with a frequency, that the lender deems appropriate given the nature of the debtor's operations.

W. Perfection Provided by Entry of the Order.

The DIP Agreement should provide, and the approval order should specifically provide, that the entry of the order acts as perfection of all security interests of the DIP lender, without further action by the lender, but the lender may, if it chooses to do so, take additional steps to perfect its security interests, and the debtor shall cooperate with those steps.

X. Waiver of Requirement to File a Proof of Claim.

Lenders are more frequently asking for waivers of the debtor's right to object to the DIP lender's pre-petition claim, which generally requires the debtor to affirm the DIP lender's claims as recited in the DIP facility, or otherwise accept the DIP lender's assertion of the claim.

IX. CONCLUSION

The foregoing is a list of some of the more frequently discussed, debated and controversial provisions that go into DIP Agreements, but is by no means exclusive. DIP Agreements and Orders should contain all of the standard provisions that a lender would use in a non-bankruptcy, non-distressed setting, and a number of bankruptcy specific provisions. The level for creativity that goes into DIP lending arrangements is unbounded.