# Lending to Bankrupt Business

*By Matt Eisenberg and Erik Lawrence*

When there's no other choice than to file for bankruptcy protection, many businesses will file for a Chapter 11 reorganization rather than a Chapter 7 liquidation.

In a Chapter 11 reorganization, the struggling business proposes a reorganization plan to keep it alive and (at least partially) pay creditors over time. During the reorganization, the business will require operating capital. But where can a bankrupt company obtain operating capital? The answer is a type of financing called debtor in possession (DIP). Creditors that provide DIP financing aren't acting irrationally; the U.S. bankruptcy code contains substantial protections for them.

## Chapter 11 basics

In most Chapter 11 cases, the company, called a "debtor in possession" (DIP), keeps possession and control of its assets, operates the business and performs many of the functions a bankruptcy trustee ordinarily performs. In typical Chapter 11 reorganizations, secured creditors have the first priority of repayment. The remaining creditors are repaid in an order determined by the bankruptcy court in accordance with the bankruptcy code. Certain expenses incurred during the reorganization process, called "administrative expenses," will be paid ahead of general unsecured claims but after secured claims.

Immediately upon filing bankruptcy and until the case is closed or dismissed, the DIP will enjoy the protection of an "automatic stay," meaning all judgments, collection activities, enforcement activities, foreclosures and repossessions of property are suspended and may not be pursued by creditors (with certain exceptions or without "relief" from the automatic stay from the court). Creditors existing before the Chapter 11 case begins are referred to as "pre-petition" creditors. The bankruptcy court can generally avoid DIP financing arrangements if they're entered into without prior court approval. Either a pre-petition creditor or a new one can provide DIP financing.

A pre-petition secured creditor that wishes to provide DIP financing may obtain a lien against collateral (real or personal property) acquired by the DIP after the case begins ("cross-collateralization"). Generally, a bankruptcy court will only approve cross-collateralization if a pre-petition creditor makes a significant commitment to provide post-petition credit.

Alternatively, a pre-petition secured creditor may seek to provide a "roll-up" loan facility, in which the DIP agrees to use cash generated post-petition to repay the creditor's pre-petition debt, and the creditor/lender agrees to extend additional credit to the DIP secured by assets acquired post-petition. Over time, a roll-up loan facility converts pre-petition secured debt to a true DIP financing facility.

A variety of entities, on the other hand, may provide new credit to a DIP. Generally speaking, the bankruptcy code provides five levels of protection for such lenders, which it can issue separately or in some combination, depending on the circumstances:

**1. Administrative expense claim.** A post-petition creditor may provide unsecured credit in the ordinary course of business (such as trade credit) without the bankruptcy court's approval. The creditor may also provide an unsecured loan outside of the ordinary course of business after notice and a hearing.

**2. "Super-priority" administrative expense claim.** If the DIP can demonstrate to the bankruptcy court that post-petition financing isn't otherwise available, it may obtain unsecured credit that's accorded administrative expense priority that's superior to all other administrative expense claims. A DIP seeking to provide a junior, senior or priming lien (discussed next) must also demonstrate this. Lenders generally seek greater protection than a super-priority administrative expense claim alone.

**3. Junior lien on an encumbered asset.** A DIP may seek to obtain credit secured by a junior lien against encumbered assets. But post-petition lenders are generally reluctant to provide DIP financing that's secured this way.

**4. Senior lien on unencumbered assets.** A DIP may seek credit secured by a senior lien against unencumbered assets. A typical DIP has few unencumbered assets and thus lenders rarely seek this level of protection.

**5. "Priming" lien.** The most sought-after level of protection is a lien that's equal or senior to an existing lien ("priming"). To provide one, the DIP must prove to the bankruptcy court the existing lienholder(s) will be "adequately protected" after the lien is granted. In general, post-petition creditors will only provide DIP financing if it's secured by a priming lien.

## Other negotiated provisions in a DIP financing agreement

A post-petition DIP lender will generally require the loan facility be secured by a priming lien and all amounts owed constitute a super-priority administrative expense claim. Such a lender will often seek relief from the automatic stay in bankruptcy court (which temporarily prevents secured creditors from enforcing their liens) and pursue its rights, including liquidation of collateral or foreclosure, upon default. In addition to typical events of default, DIP financing loan agreements should contain the following so the DIP lender can enforce its rights ("call" the loan, foreclose on assets, etc.) if: the Chapter 11 case is dismissed or converted to a Chapter 7; the bankruptcy court appoints a trustee or an examiner with expanded powers; the DIP incurs additional post-petition debt outside the ordinary course of business; the bankruptcy court modifies the order in which it originally authorized the DIP financing facility; the bankruptcy court grants relief from the automatic stay to any holder of a junior lien in the collateral that secures the DIP facility; and any post-petition judgments are entered against the DIP.

Although we banish the thought from our everyday reality, we know the number of companies seeking Chapter 11 bankruptcy protection will likely increase in the coming months as a result of the economic downturn. Creditors willing to navigate the recesses of the bankruptcy code may find that providing DIP financing on protected terms is a worthwhile—and even profitable—endeavor.

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