Article

What Every Bankruptcy Attorney Needs to Know About Cash Collateral and DIP Financing

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In most Chapter 11 bankruptcy cases, a debtor[1] will need to use cash that is subject to a lien of a secured creditor and/or obtain postpetition financing to continue operating postpetition. Section 363 of the Bankruptcy Code permits a debtor to use such encumbered cash (and its proceeds, collectively cash collateral) to satisfy a debtor's postpetition expenses.[2] In most Chapter 11 cases, however, a debtor cannot rely solely on its existing cash balance or postpetition accounts receivable to meet its postpetition obligations. As such, Section 364 of the Bankruptcy Code permits the extension of postpetition credit to a debtor (DIP financing).[3] For a debtor to be permitted to use cash collateral or receive DIP financing, however, a debtor may be obligated to satisfy several conditions.

The Bankruptcy Code recognizes that, absent protection, some lenders may be reluctant to either consent to a debtor's use of cash collateral or provide a debtor DIP financing because the debtor only recently chose to pursue bankruptcy protection, very often without the lender's consent. Therefore, to encourage secured lenders to allow the use of cash collateral and the extension of DIP financing, the Bankruptcy Code provides lenders certain incentives and protections.[4] Thus, a lender that is willing to consent to cash collateral or extend DIP financing will naturally want to receive as many protections and incentives as it can to protect its collateral ensure repayment.

On the other hand, a debtor will almost always want to use cash collateral and obtain DIP financing with the least amount of strings attached as possible. A debtor, however, may be reluctant to take a hard stance against a lender in negotiating terms of cash collateral use and DIP financing because the debtor has little bargaining power and needs the lender's cooperation. Thus, in bankruptcy cases in which an unsecured creditors' committee was appointed, the committee will often play a critical role in the negotiations with the lender. Like a debtor, an unsecured creditors' committee will typically encourage use of cash collateral and DIP financing. But, the committee will oppose terms and conditions being demanded by a lender if they are overreaching and will ultimately decrease distributions to the committee's constituency.[5]

Cash Collateral

The Bankruptcy Code defines cash collateral as including "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents ... in which the estate and any entity other than the estate have an interest ..."[6] Put plainly, cash collateral is comprised of a debtor's collateral (which usually includes accounts receivables) and its proceeds.

Statutory Requirements to Obtain It

There are several ways in which a debtor may obtain use of cash collateral. The simplest way for a debtor to obtain use of cash collateral is by first receiving the secured creditor's consent. Alternatively, a debtor may obtain use of cash collateral if, at a hearing on the matter, the debtor demonstrates that the secured lender's interest in the cash collateral is adequately protected.[7]

Valuation of Collateral
To ensure that a secured lender receives sufficient adequate protection, it is important to determine the value of the lender's secured claim early on in the bankruptcy case. Essentially, a lender's secured claim is equal to the sum of the value of its collateral as of the petition date (plus any property the secured lender holds that is subject to setoff).[8]

In determining the value of a secured lender's collateral, courts have employed varying methods of valuation depending on the facts of the case. Therefore, the key parties in a bankruptcy case should measure a secured lender's collateral using fair market value, liquidation value, and going concern value.[9]

In the event there is some later dispute as to whether a secured lender is adequately protected, the key parties in the case may measure the value of the collateral again, at which point the previous calculations will be helpful in determining the extent, if any, in which the adequate protection proved insufficient.

In the event adequate protection proves to be insufficient, the lender should receive a superpriority claim for the deficiency.[10] A superpriority claim is an administrative claim that is given a higher priority than all other administrative expense claims, even professional fees.

Therefore, if there is subsequently a dispute as to whether adequate protection provided to the lender was sufficient, the debtor and the unsecured creditors' committee may argue that the collateral securing the secured lender's claim at the commencement of the bankruptcy case had a relatively low value as compared to the value of the collateral adequately protecting the secured lender at the end of the case. By making this argument, the debtor and committee hope that the bankruptcy court will find the adequate protection proved sufficient, thus granting a superpriority claim to the lender is unnecessary.

In stark contrast, the secured lender will likely argue that the value of the collateral securing its claim at the commencement of the case had a relatively high value as compared to the value of the collateral adequately protecting the secured lender at the end of the bankruptcy case. By making this argument, the secured lender hopes that the bankruptcy court will find the adequate protection proved insufficient, thus entitling the lender to a superpriority claim for the deficiency.

Miscellaneous Procedures and Requirements
A debtor must segregate and account for any cash collateral in its possession, custody, or control.[11] This duty begins on the petition date and continues throughout the pendency of the bankruptcy case.

The proper means of seeking use of cash collateral is by motion. The motion should provide at a minimum: the name of the secured lender; the purpose of the debtor's use of cash collateral; the material terms of such use, including duration; and a description of adequate protection to be provided to affected secured parties.[12] Because bankruptcy courts may sometimes be unpredictable, very often the key parties will agree to the terms of cash collateral usage.

In its motion, a debtor may request that a hearing on use of cash collateral be broken up into a preliminary hearing and a final hearing. The reason for such a request is that a court may not hold a final hearing on the debtor's use of cash collateral within 14 days after service of the motion requesting the relief. However, if the court holds a preliminary hearing (which will occur before the 14-day period expires), it may authorize preliminary use of cash collateral, but only if such use is "necessary to avoid immediate and irreparable harm to the estate."[13]

Key parties to a bankruptcy case should never assume that a particular secured lender has a perfected, lien interest in cash collateral. A careful review of the applicable plan documents, including the financing statements, is always the best practice.

DIP Financing

DIP financing is financing that a debtor may obtain following the commencement of its bankruptcy case. Much like use of cash collateral, DIP financing is critical to most debtors that choose to reorganize, particularly if a debtor cannot satisfy its postpetition expenses solely using cash collateral.[14] DIP financing is available in both unsecured and secured form, each of which provides a secured lender with incentives and protections to encourage it to lend money to a debtor.

A debtor may obtain unsecured financing without court approval so long as it is in the ordinary course of the debtor's business or industry.[15] Nevertheless, it is the best practice to always obtain prior court authorization before entering into a postpetition credit facility. By doing so, the lender avoids a situation where the bankruptcy court later finds the extension of credit was outside the ordinary course and, as a result, denies the lender an administrative claim.[16] An unsecured loan to a debtor that is considered outside of the ordinary course requires notice and a hearing.[17] If the court determines that the loan is being made for a legitimate business purpose, the lender will be awarded an administrative claim for the amount advanced and unpaid.[18]

In the event a debtor cannot obtain unsecured financing following the commencement of its bankruptcy case, which is likely, the bankruptcy court may allow it to receive financing in exchange for providing the lender a superpriority administrative claim, a lien on the debtor's unencumbered property, or a junior lien on the debtor's encumbered property.[19]

As mentioned, a superpriority claim is an administrative claim for any deficiency of adequate protection. In the context of DIP financing, a lender who is given a superpriority claim in exchange for extending credit to a debtor will have an administrative claim to the extent that any other type of adequate protection extended to it proves insufficient.[20]

If a debtor is unable to obtain an unsecured loan or a secured loan in exchange for a superpriority claim, replacement lien, or junior lien, the bankruptcy court may authorize the debtor to obtain secured credit by granting a lender a senior or equal lien.[21] While a debtor must make reasonable efforts in attempting to secure other means of financing, the debtor need not exhaust every lender before deciding that such credit is unavailable.[22]

Lender's Terms

Because lenders hold most of the bargaining power when negotiating cash collateral and DIP financing with a debtor, lenders are often coming up with creative terms that will assist in making sure they are adequately protected and fairly compensated. Sometimes, however, such terms can be construed as far more overreaching than necessary. The following is a list of terms that are very often found in proposed orders for cash collateral and DIP financing that are considered controversial by many bankruptcy courts.

Cross-Collateralization

There are two types of cross-collateralization. Forward cross-collateralization occurs when a prepetition debt is secured by postpetition collateral. This type of cross-collateralization is controversial and is not allowed in some courts and heavily scrutinized in others. Backward cross-collateralization occurs when a postpetition debt is secured, in part, by prepetition collateral. Unlike forward cross-collateralization, backward cross-collateralization is far less controversial.[23]

Roll-Ups

Another way secured lenders may attempt to improve their prepetition indebtedness is through "rolling up" their prepetition debt into a postpetition advance of cash collateral or credit. In considering whether to permit a postpetition facility that is contingent upon a roll-up, bankruptcy courts should consider whether: the proposed order requesting a roll-up is an interim or final order; the administrative claim granted to the prepetition secured lender gives it a "veto" over any plan; there is a substantial negative impact on unsecured creditors; and any exceptional circumstances justifies the roll-up.[24]

Chapter 5 Causes of Action
The granting of a superpriority claim or lien on avoidance actions (or proceeds) to a secured lender is a very controversial practice. Many courts prohibit the conveyance of interests in avoidance actions, reasoning that such actions are particular to bankruptcy to ensure equal distributions to similarly situated creditors, and the granting of superpriority claims or liens in such actions or proceeds to the secured lender undermines their purpose.[25] Regardless of a particular court's temperament on conveying an interest in Chapter 5 causes of action to a secured lender, a court is less likely to grant such provision on an interim basis.[26]

Waivers
Proposed orders for cash collateral or DIP financing will often include various waivers. Examples of common waivers include: that the secured lender's lien is valid, fully perfected and senior to all other liens; and that the debtor will not file a proposed Chapter 11 plan without the lender's consent. Increasingly, such waivers are being scrutinized by bankruptcy courts, particularly on an interim basis, because they prevent the debtor and the unsecured creditors' committee from fulfilling their fiduciary obligations of investigating claims against the bankruptcy estate.[27]

As for waivers of Section 506(c), which allow a trustee to surcharge a secured creditor's collateral to the extent an administrative claimant has benefited from it, most bankruptcy courts will not allow such waivers because the Supreme Court has construed 506(c) as giving a trustee exclusive standing, and a waiver of 506(c) is generally viewed as waiving an important right belonging to creditors.[28]

Conclusion
Very often a debtor who seeks Chapter 11 relief will enter in the reorganization process with limited cash flow. Accordingly, Sections 363 and 364 of the Bankruptcy Code provide incentives to secured lenders for allowing the debtor to use cash collateral and obtain DIP financing. For if the debtor is unable to use cash collateral or obtain DIP financing, it will likely cease operating and be forced to liquidate all of its assets.

While Sections 363 and 364 of the Bankruptcy Code provide sufficient incentives to secured lenders, such that a debtor with a going-concern value should be able to obtain use of cash collateral or DIP financing, it is important for a debtor and other creditors to make sure that the terms of such use do not give a lender too much control or value in return. Indeed, agreements to allow cash collateral usage and DIP financing usually occur early in the bankruptcy case and can significantly impact its outcome. If a party has a firm understanding of the dynamics of cash collateral usage and DIP financing, allowing it to negotiate a favorable agreement, such positioning may prove advantageous throughout the remainder of the case.

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1 While 11 U.S.C. §§ 101, et seq. (the "Bankruptcy Code") and specifically Sections 363 and 364 of the Bankruptcy Code refer to the "trustee," Section 1107 of the Bankruptcy Code gives a debtor-in-possession all of the rights of a trustee appointed to a bankruptcy case administered under Chapter 11 of the Bankruptcy Code. Any reference in this article to a "debtor" shall mean either a debtor-in-possession or a Chapter 11 trustee.
2 11 U.S.C. § 363(c)(2) (2010); see also Johnathan C. Bolton, et al., *Cash Collateral Use and Debtor-in-Possession Financing* (State Bar of Tex./Nuts & Bolts of Bus. Bankr. Course, Austin, Tex.), Apr. 30, 2008, Chp. 2.1, at 1.
3 11 U.S.C. § 364; *see* Bolton, *supra* note 2, at 1.
4 *See* Hon. Barbara J. Houser, et al., *Current Issues in Debtor in Possession Financing; The Art of Bankruptcy Financing: When does a Pig Become a Hog?* (Nat'l Conf. of Bankr. Judges, Chicago, Ill.), Oct. 2, 2002, at 2-7 (on file with author).
5 *See* Bolton, *supra* note 2, at 1.
6 11 U.S.C. § 361.
7 Adequate protection is defined in 11 U.S.C. § 361 and *includes*: (i) periodic cash payments equal to the

reduction of a secured creditor's interest; (ii) a replacement lien equal to the reduction of a secured creditor's interest; and (iii) the indubitable equivalent to the reduction of a secured creditor's interest.
8 *See* 11 U.S.C. § 506(a).
9 Berry D. Spears, *Is it Ready Yet? Grilling the Lawyers on Cash Collateral and DIP Financing Orders* (State Bar of Tex./Advanced Bus. Bankr. Course, Houston, Tex.) May 18-19, at § II-D.
10 *See* 11 U.S.C. §§ 503(b), 507(b).
11 11 U.S.C. § 363(c)(4).
12 Fed. R. Bankr. P. 4001(b)(1).
13 *See id.* at 4001(b)(2).
14 Bolton, *supra* note 2, at 1.
15 11 U.S.C. § 364(a). Several courts apply a two-prong test in determining whether a particular act is within the "ordinary course" of the debtor's business--(i) the horizontal dimension test and (ii) the vertical dimension test. Applying the horizontal dimension test, the court will determine whether it is common in the debtor's industry. And, in applying the vertical dimension test, the court will determine if the debtor's creditors would consider it to be consistent with the debtor's prepetition acts. If both of these prongs are satisfied, then the act should be construed as ordinary course. See Bolton, *supra* note 2, at 2-3 (citing 2 Collier on Bankruptcy, 364.02[2] (15th ed. rev'd)).
16 *See* Houser, *supra* note 4, at 2-8.
17 See 11 U.S.C. § 364(b).
18 *See* Houser, *supra* note 4, at 2-8.
19 11 U.S.C. § 364(c).
20 *See* 11 U.S.C. §§ 364(c)(1), 507(b). Accordingly, a "carve out" for reasonable professional fees is appropriate. See Houser, *supra* note 4, at 2-8.
21 11 U.S.C. § 364(d).
22 Bolton, *supra* note 2, at 3.
23 Houser, *supra* note 4, at 2-15.
24 *See id.* at 2-16-17.
25 *See id.* at 2-10-11. Note that this reasoning is less persuasive if the debtor is proposing a Chapter 11 plan that satisfies creditors in full.
26 *See id.* at 2-11.
27 *See id.* at 2-12.
28 *See id.* at 2-17.

Primary Contacts

Kevin Lippman
Dallas
214.855.7553
klippman@munsch.com

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