Understanding DIP Financing Order — Look a Little Closer

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THE HEADLINE. The typical Chapter 11 debtor (the entity that is in bankruptcy) issues a press release shortly after commencing its bankruptcy case announcing to the world that the debtor has obtained "DIP" (debtor in possession) financing. The headline is a big number. The goal is to obtain new, post-bankruptcy trade credit from suppliers by convincing them that the Chapter 11 debtor now has liquidity sufficient to enable the debtor to pay its bills on time. Therefore, give the debtor more credit.

SO, WHAT'S LEFT? Assume that a debtor owes its bank $20,000,000 pre-bankruptcy. Also, assume that the bank has a "blanket" lien – a lien that covers all of the debtor's assets. When I review a debtor's financing, my first inquiry is whether or not there are any unencumbered assets from which I can be paid if the case becomes Chapter 7 liquidation or in case the bank forecloses on its collateral.

If the bank has a lien on everything, my second question is whether the bank is obtaining any new, additional collateral.

YOU REALLY WANT MY CLIENT TO HELP GET THE BANK PAID? I check to see if a lien is being given on preference actions – claims that the debtor's estate has against its own creditors to recover money that was paid to creditors during the 90 days preceding the date of bankruptcy for payments made on account of debts that were past due at the time of payment. In other words, is the bank getting a lien on the debtor's claims against vendors like my client? This potentially causes unsecured creditors to subsidize the bank if the bank is not paid in full from its other collateral. In these situations, I view granting post-petition credit with a much more jaundiced eye.

In evaluating how wonderful is the debtor's DIP financing, the question is how many dollars the debtor actually nets after paying assorted fees and after taking into account loans that must be paid off in order to receive the DIP new loan or taking into account the amount of an existing loan that may be rolled (converted) into the new loan. A $20,000,000 DIP loan is a lot less impressive if the debtor must pay off a $19,000,000 prepetition loan and also pay $500,000 of fees in order to get the $20,000,000 loan. There would only be $500,000 left over for additional working capital. That is not nearly as impressive a headline as was $20,000,000.

ADD IT UP. There is a lot of money to be made by lenders to Chapter 11 debtors. Typically, the base interest rate is higher than outside of bankruptcy. Then there is the default rate (usually about 2-4 points higher than the base rate). The facility fee for the privilege of obtaining a DIP loan from the bank can be 25-50 basis points. There also may be a fee for paying off the bank upon exiting bankruptcy - a prepayment penalty. And, there may be an unused line fee (discussed below) in addition to paying the bank's attorney and financial advisor. Finally, there are audit or monitoring fees to make the bank whole for its internal oversight of the loan while the debtor is in Chapter 11.

PAYING FOR SOMETHING NOT OBTAINABLE. The "unused line fee" – a fee that the bank charges to the borrower in exchange for the bank making the credit line or loan *available* to the borrower is very misleading. The amount of the bank's commitment is based upon the borrower meeting certain conditions. For example, the bank may charge a fee of 25 basis points on a $20,000,000 commitment to the borrower; but, the ability of the borrower to actually get $20,000,000 out of the bank is dependent upon the borrower having sufficient collateral. The amount of the debtor's actual borrowing capability typically is a function of the advance rates against receivables and inventory, for example, as well as the amount of ineligibles and reserves applied to the collateral. Consequently, a debtor that has a $15,000,000 outstanding pre-petition loan and receives a $20,000,000 DIP loan commitment may really be maxed out on its borrowing ability at $15,000,000. There won't be another $5,000,000 available to the borrower because the formulae that apply to the borrower's assets only permit $15,000,000. So, the debtor pays an unused line fee on the extra $5,000,000 that it never will be able to access.

THE TRUE COST. In calculating the real cost of money, the numerator is the aggregate of all of the interest charges and other fees. But, the DIP financing may not necessarily be a full, one-year loan. It may have milestones for a sale or for emergence from Chapter 11. If it is a six-month loan, then it is not as simple as adding up all of the fees and interest and dividing by the amount of the loan. What is the *aggregate* amount of money that the borrower would be paying if the various fees and expenses were *doubled* in addition to paying interest for another six months? In other words, if the borrower took out the same loan twice over and paid the same interest, fees and expenses twice over. Then, divide that combined number by the outstanding amount of the loan (not the loan commitment). It is easy to see that the effective cost of money can approach usury. The DIP loan suddenly does not look as good. Don't be taken in by the headlines when additional credit is requested of you.

KNOW WHEN TO PULL BACK. A creditor sometimes finds itself in the position of *having* to extend post-petition credit because the debtor is very important to the creditor's business. In such circumstances, the creditor still is not without remedies. First, look at the milestones contained in the financing. For example, there may be deadlines to file a plan of reorganization, repay the DIP loan or to complete a sale of the debtor's assets. A prudent vendor that extended post-petition credit should stay well ahead of those deadlines and be focused on pulling back on credit terms, depending upon the status of the case, or else satisfying itself that it is not at material risk. Does the plan of reorganization or does the sale of assets provide enough funds to satisfy all administrative (post-petition) claims?

IF ALL ELSE FAILS. If you have gotten into a bind, remember that the Bankruptcy Code says, generally, that all administrative claims are to be treated equally. So, the post-petition claim of a trade vendor is supposed to have the same status as the professional fees due to attorneys and financial advisors. It is not expensive to file objections to the payments of professional fees and assert that your claim should be treated equally to the claims of professionals. Then just wait for the professional to panic and to deal with his/her client.

Section 503(a) of the Bankruptcy Code permits an unpaid administrative creditor to file an application for payment of a past due administrative claim. It is relatively quick and inexpensive to prepare and get onto the Court's calendar. Most debtors abhor such a motion because of the potential domino effect when other vendors become aware of the motion.

The above reveals that headlines proclaiming a debtor has secured a large amount of DIP Financing are not necessarily a green-light to provide continued trade credit. The details behind the headlines must be fully explored, understood and monitored in order to make a fully informed decision on continued trade credit extensions to a debtor.

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He advises on the full spectrum of restructuring solutions, including Chapter 11 reorganizations, out-of-court workouts, financial restructurings, and litigation. He works closely with debtors, creditors' committees, lenders, landlords, and others in such diverse industries as paper and printing, food, furniture, pharmaceuticals, health care, and real estate.

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