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# PURE DEBTOR-IN-POSSESSION FINANCING

By Richard M. Kohn, Alan P. Solow and Douglas P. Taber

**D**ebtor-in-possession financing often inspires unease, misgivings and anxiety in commercial lenders because most lenders deal with it only when their ailing borrower files a Chapter 11 petition. The lender often agrees to extend debtor-in-possession financing to its borrower only to avoid having, and possibly losing, a cash collateral fight. Often, the lender must make a number of concessions — to the debtor, to the committee of unsecured creditors and to the judge — as the price of obtaining a consensual debtor-in-possession financing order instead of a non-consensual cash collateral order.

Some imaginative lenders, however, have discovered how to make debtor-in-possession financing a lucrative and comparatively secure source of new business. These lenders seek out opportunities to extend debtor-in-possession financing to companies in Chapter 11 with whom they have no prepetition lending relationship. Because these lenders have much more leverage than a typical lender whose borrower has filed for bankruptcy, they are able to obtain financing orders without having to make the type of concessions that are regularly made by the typical lender. As a result, their interests are much better protected during the bankruptcy case. These lenders are engaged in what can be called “pure” debtor-in-possession financing. If, as many lenders predict, a wave of new Chapter 11s is looming on the economic horizon, the opportunities for lenders to engage in pure postpetition financing transactions are likely to increase.

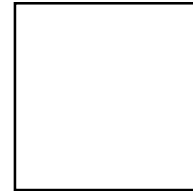
## **The debtor-in-possession**

In a Chapter 11, unless a trustee is appointed, the debtor retains control over its assets, business operations and reorganization efforts as debtor-in-possession (DIP). Therefore, although the debtor’s prepetition management will usually continue to control operations, the DIP must obtain authorization from the Bankruptcy Court before it can obtain postpetition financing. As part of such authorization, the DIP must obtain the entry of a financing order granting it authority to borrow and to encumber its assets and providing the lender with certain rights and remedies. The DIP must also execute the necessary loan documents

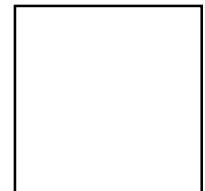
which will function much the same inside, as outside, of Chapter 11. In conventional postpetition financing situations, the DIP often merely adopts or ratifies the existing prepetition loan documents as part of the financing order. In the pure postpetition context, however, the DIP must execute new loan documents prepared pursuant to the terms of a commitment letter. The commitment letter in pure postpetition financing situations is generally issued before the commencement of the Chapter 11, even though the lender will actually extend financing to the DIP after the case is commenced.



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Upon or shortly after the commencement of the Chapter 11, the DIP will file a motion for authorization to obtain postpetition financing. Federal Rule of Bankruptcy Procedure 4001(c)(1) requires that this motion be accompanied by “a copy of the agreement.” Ideally, the motion should be accompanied by a copy of the proposed financing order and copies of the proposed underlying loan documents; however, in the pure postpetition financing situation, drafts of the underlying documents may not have been completed by the time the motion is filed. In this situation, a copy of the commitment letter should accompany the motion. Drafts of the loan documents can follow as soon as they have been prepared.

The motion for authorization to obtain postpetition financing will often involve a two-step process. The first step will be the entry of an “interim” financing order authorizing borrowing in a strictly limited amount to enable the DIP to function for a short period of time (generally a

few weeks) while notice of the final hearing on the motion goes to all appropriate parties. The second step will be the entry of a “permanent” or “final” financing order authorizing borrowing in the full amount of the lender’s commitment. However, particularly in the pure postpetition financing context, the DIP may have sufficient alternative funds available to enable it to bypass the interim financing order step and to go directly to a hearing on the final financing order.

### **The creditors’ committee**

Shortly after the commencement of the Chapter 11, the United States trustee will usually appoint a committee of unsecured creditors. The trustee may also appoint other committees, such as committees of bondholders and equity interest holders. The trustee will generally appoint the creditors’ committee between the entry of any interim financing order and the entry of the final financing order. In fact, bankruptcy judges will generally postpone the hearing on the final financing order until the creditors’ committee can organize and retain counsel. Because the creditors’ committee will usually be in a position to object to the proposed terms of the final financing order and to appeal the entry of any final financing order, it is almost always very actively involved in the negotiation of the terms of the postpetition financing.

### **Walk-away leverage**

The lender in a pure postpetition financing arrangement has a number of important advantages over a prepetition lender who is considering extending postpetition financing to the DIP. The pure postpetition lender can walk away from the deal more easily than a prepetition lender. The prepetition lender may have considerably less leverage in negotiations with the DIP and the creditors’ committee due to (1) the prepetition lender’s desire to protect the value of its existing collateral and to limit its losses by controlling the DIP’s financing to the greatest extent possible pursuant to a consensual financing order as opposed to a nonconsensual cash collateral order, (2) the threat that the DIP will obtain court authority to use the prepetition lender’s cash collateral without the lender’s consent, (3) the threat that the DIP will obtain court authority to grant a “priming lien” to a new postpetition lender pursuant to Section 364(d) of the Bankruptcy Code, and (4) the threat of lender liability litigation, including fraudulent conveyance litigation and preference litigation, based on the prepetition lender’s past conduct.

### **Less court scrutiny and enhanced rights and remedies**

Some bankruptcy judges scrutinize proposed financing orders more closely than others. Most bankruptcy judges, however, are likely to be less suspicious of a pure postpetition lender because they are often concerned about attempts by a prepetition lender to use a postpetition

financing order to improve its status as a prepetition creditor by, for example, including in the financing order (1) a provision cross-collateralizing prepetition debt with postpetition collateral, (2) a finding by the court regarding the validity, priority and extent of the lender’s pre-petition liens, and (3) a release of any claims which the DIP and its estate may have against the lender, including fraudulent conveyance claims, preference claims and other lender liability claims. In comparison, the pure postpetition lender is a market participant whose overreaching conduct should, at least theoretically, be checked by the competition of the marketplace. In fact, some bankruptcy judges may view the pure postpetition lender as a “favorite of the court,” and many will allow such lender to obtain rights and remedies under the financing order which they would rarely, if ever, allow to a DIP’s prepetition lender. Among the most important of these rights and remedies are the ability to prospectively lift the automatic stay and the ability to prevent the DIP from subsequently using the lender’s cash collateral without the lender’s consent.

### **Impossibility of cramdown**

Because all of the pure postpetition lender’s claims against the DIP should be entitled to “superpriority” claim status under Section 364(c)(1) of the Bankruptcy Code, the pure postpetition lender will be entitled to have all of its claims paid in cash, in full, on the effective date of any plan of reorganization pursuant to Section 1129(a)(9)(A) of the Bankruptcy Code. As a result, this claim, unlike the prepetition claim of a prepetition lender, cannot be “crammed down,” i.e., cannot receive nonconsensual treatment under a plan of reorganization.

### **Acceptance of commitment prepetition**

Although the commitment letter extends postpetition financing to the DIP subsequent to the commencement of the Chapter 11, the lender should, if possible, issue the letter and have it accepted by the debtor *prior* to the filing of the Chapter 11. The debtor’s *prepetition* acceptance of the commitment letter and payment of the commitment fee and expense deposits will not require bankruptcy court approval. These same actions, however, must be authorized and approved by the bankruptcy court when taken postpetition.

### **Amount and timing of payment**

Commitment fees are often within the range of fees for comparable loans outside of bankruptcy. To the fullest extent possible, however, a pure postpetition lender should seek to “front-load” the payment of the commitment fee by requiring the debtor to pay the fee both prepetition and either prior to, or contemporaneously with, the debtor’s acceptance of the commitment letter. The debtor’s prepetition payment of the commitment fee does not need court approval. If, however, the commitment fee is not paid prepetition, the bankruptcy court will probably link approval

of payment of the commitment fee to the entry of the financing order. In these situations, if the financing order is not ultimately entered for any reason, the commitment fee will probably not be paid at all. Accordingly, the prepetition payment of the fee enhances the lender's ability to walk away from the deal without losing all benefits.

### Protection against voidable preference and fraudulent transfer exposure

The prepetition payment of the commitment fee may be attacked in bankruptcy as a voidable preference if it was not paid prior to, or contemporaneously with, the execution of the commitment letter. See Sections 547(b), (c)(1) and (c)(4) of the Bankruptcy Code. If the commitment fee is unreasonably large, its prepetition payment could also be subject to attack as a fraudulent transfer made for less than reasonably equivalent value. See Section 548 of the Bankruptcy Code. Commitment fees paid prepetition, however, should not be subject to avoidance and recovery postpetition if the fees are (i) paid prior to, or contemporaneously with, the debtor's acceptance of the commitment letter and (ii) reasonable in amount in light of the market and the debtor's financial condition. Because such fees should be seen as payments made in exchange for the lender's commitment to extend postpetition financing to the DIP under the terms and conditions set forth in the commitment, rather than as payments made in exchange for the actual financing, the lender should be able to keep its fees even if the postpetition financing itself is never approved.

### Expense deposit

If at all possible, the lender should obtain a substantial expense deposit from the debtor at the time the debtor accepts the commitment letter. The expense deposit should be large enough to cover all costs and expenses, including attorneys' fees, likely to be incurred through the date of the entry of the final financing order. Receipt of such a deposit will enhance the lender's walk-away leverage. However, if it is not large enough to ultimately cover all of the lender's outstanding attorneys' fees and costs incurred through the date of the hearing on the final financing order, the lender will be out-of-pocket for its excess fees and expenses if no financing order is entered. Therefore, to the extent practicable, the commitment letter should also provide for the *prepetition* replenishment of the expense deposit to minimize the possibility that a shortfall will ultimately exist.

### Unused line fees and closing fees

Other fees, including unused line fees, letter of credit fees, early termination fees and closing fees, may generally be obtained within the range of similar fees earned in comparable loans outside of bankruptcy. Occasionally, particularly when the DIP is a retailer, it will want to obtain a DIP loan facility primarily to convince its suppliers to extend it trade credit by demonstrating that it has financing available to

enable it to pay postpetition trade claims. In such situations, the DIP may not intend to draw heavily, if at all, on the facility. Unused line fees can be particularly meaningful for a lender in these "window-dressing" situations. In these situations the lender also may not advance for some time, if at all, after the entry of the financing order. Thus, closing fees should be deemed earned and payable upon entry of the financing order, instead of upon funding.

### Enhancement fees

In *In re Defender Drug Stores, Inc.*, 126 B.R. 76 (Bankr. D. Ariz. 1991), the court authorized payment of an "enhancement fee" to a postpetition lender who extended the original maturity date of the postpetition facility in order to enable the DIP to conduct a sale of its business as a going concern. As a result of the successful sale, the lender received a fee equal to ten percent over and above the amount of its claim. This case should be kept in mind if and when the lender is asked to continue funding or to forbear from exercising its rights and remedies following the DIP's default or any other event which would trigger the termination of the loan facility.

### Special bankruptcy provisions in commitment letter

The commitment letter may be in the form used by the lender generally, but should also include certain bankruptcy-specific terms and conditions for inclusion in the financing order. The following are strongly suggested:

A requirement that the lender's claim for repayment of the loans will be (i) entitled to superpriority claim status, pursuant to Section 364(c)(1) of the Bankruptcy Code, over all administrative expense claims incurred in the Chapter 11 case and (ii) secured by a first and only lien on substantially all of the DIP's property;

- A requirement securing repayment of the loans by a lien on avoidance actions and avoidance action recoveries, including fraudulent conveyance recoveries and voidable preference recoveries;
- A requirement allowing the lender to cease financing immediately upon an event of default;
- A requirement lifting the automatic stay with respect to the lender upon the entry of the financing order, so that the lender will not need to obtain such relief following the DIP's default, or upon any other termination of the loan facility, before it can exercise its rights and remedies under the financing order and the loan documents;
- A requirement prohibiting the DIP's nonconsensual use of the lender's cash collateral after an event of default or other termination of the loan facility;



➤ A requirement that the financing order, including any interim financing order, will contain a specific finding that the lender has acted in “good faith,” within the meaning of Section 364(e) of the Bankruptcy Code. This good faith finding should protect the validity and priority of the lender’s postpetition claims and liens in the event the financing order is reversed or modified on appeal;

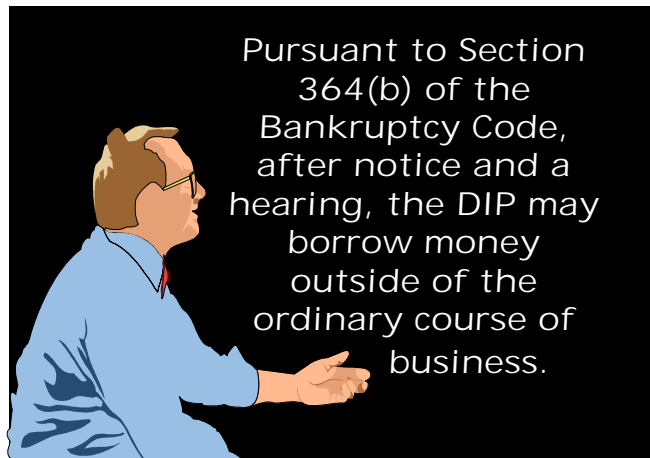
- A requirement insulating the lender’s collateral from statutory charges for its preservation or disposition under Section 506(c) of the Bankruptcy Code, or otherwise;
- A requirement that the financing order and the loan documents will terminate prior to the maturity date set forth in the commitment letter upon (i) the appointment of a trustee, (ii) the dismissal of the case, (iii) the conversion of the case to a Chapter 7 liquidation, (iv) the payment of any prepetition claims without lender’s consent, or (v) any other default;
- A provision that any appeal of the final financing order taken by any party in interest will constitute an event of default; and
- A requirement making the terms and conditions of the financing order binding upon the DIP’s successors, including any subsequently appointed trustee. The inclusion of these bankruptcy-specific terms and conditions in the commitment letter should enhance the lender’s argument in negotiations that it simply cannot live without such terms and conditions.

### Termination of the commitment

The commitment letter should provide that if a financing order has not been entered and the loan has not closed by a certain outside date, for any reason whatsoever, the commitment shall expire and all paid commitment fees shall be retained by the lender. This provision will enhance the lender’s leverage over the DIP, the creditors’ committee and other parties in interest because such parties will either be forced to agree to a deal or run the risk of the DIP losing its financing and possibly being forced into a liquidation. The provision will also protect the lender from running up fees and expenses that the lender will be unlikely to recover unless a financing order is ultimately entered.

### Interim financing order issues

*Notice* — immediate and irreparable harm. Pursuant to Federal Rule of Bankruptcy Procedure 4001(c), the Bank-



ruptcy Court may not commence a final hearing on the DIP’s motion for authorization to obtain postpetition financing on less than 15 days’ notice. Before that 15-day notice period expires, the DIP may obtain interim financing only “to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing.” It is a good idea for the lender, however, to require the DIP to also provide parties in interest

(including the creditors’ committee, or, if no such committee has been appointed, the 20 largest unsecured creditors) with the best notice possible of the interim financing hearing. Actual, meaningful notice of the interim financing hearing is important because the most strenuous negotiations and the filing of objections usually occur after the entry of the interim financing order but before the hearing on the final financing order. If the lender finances pursuant to an interim order and the bankruptcy judge later fails to enter a final order in the form required by the lender, for whatever reason, the lender runs the risk that the bankruptcy judge may not enforce the more aggressively pro-lender provisions of an interim financing order entered before the creditors’ committee was formed and retained counsel. This risk is increased if the interim order was entered on limited notice.

*Interim financing orders in the pure postpetition financing context* — Because of the risk of financing pursuant to an interim financing order, a pure postpetition lender may wish to extend postpetition financing only pursuant to a final financing order. Going straight to a final financing order hearing may be possible if the DIP either has sufficient unencumbered funds on hand, or sufficient “cash collateral” of its prepetition lender, to enable it to operate without new financing until the final financing order hearing. Accordingly, the lender may wish to agree to extend interim financing only if it is impractical or impossible for the DIP to survive on its available cash or cash collateral until the final hearing. If the lender does agree to finance the DIP pursuant to an interim financing order, the interim financing order should specifically terminate on the date of the final hearing, unless extended by agreement, so as to avoid a situation where the lender may arguably be obligated to continue to finance pursuant to the interim financing order.

### Liens and priorities

Section 364 of the Bankruptcy Code allows a DIP to obtain credit pursuant to a variety of arrangements, not all of which are likely to appeal to a pure postpetition lender.

*Borrowing with an administrative claim priority* — Pursuant to Section 364(b) of the Bankruptcy Code, after notice and a hearing, the DIP may borrow money outside of the ordinary course of business. A lender who loans money to the DIP under this Section is entitled to have its loan repaid as an unsecured administrative expense claim (which has the same priority as the claims of the DIP’s counsel and other professionals retained by the estate for payment of professionals’ fees and expenses). However, because DIPs not infrequently find themselves unable to pay all of their administrative expense claims in full, no prudent lender should agree to lend money to a DIP on this basis.

*Superpriority borrowing* — Pursuant to Section 364(c)(1) of the Bankruptcy Code, if the DIP is unable to obtain unsecured credit as an administrative expense claim, the DIP, upon notice and a hearing, may borrow money with repayment entitled to priority *over* all administrative expense claims. This type of claim is known, in bankruptcy jargon, as a “superpriority” claim. A lender who holds a Section 364(c)(1) superpriority claim is entitled to be paid from all unencumbered property of the estate prior to payment of the Chapter 11 claims of any prepetition unsecured creditor or any administrative claimant. Because Section 364(c)(1), however, does not provide the lender with a lien on specific property, a superpriority claim in and of itself does not entitle the lender to enforce its right to payment directly against specific assets if the case is dismissed or if the lender obtains relief from the automatic stay. In the event of a liquidation, however, the DIP, the Chapter 11 trustee or the Chapter 7 trustee, as the case may be, would be obligated, as a matter of law, to use all proceeds of unencumbered property of the estate to pay the lender’s superpriority claim before paying any claims, including any administrative expense claims, incurred during the pendency of the Chapter 11. Another disadvantage of the superpriority claim is that at least one court has held that administrative expense claims incurred by a Chapter 7 trustee following the conversion of the case to a case under Chapter 7 (the so-called “burial expenses”) have priority over the lender’s Chapter 11 superpriority claim. *In re Summit Ventures, Inc.*, 135 B.R. 478, 483 (Bankr. D. Vt. 1991). An advantage of the superpriority, however, is that it can be used to give the lender the right to first payment out of proceeds of assets the lender may not be able to encumber with a lien, such as avoidance action recoveries. Therefore, although the superpriority is definitely worth having, a prudent lender will try to combine the superpriority with a first priority lien on the DIP’s assets because of the shortcomings of the superpriority.

*Secured borrowing* — If the DIP is unable to obtain unsecured credit as an administrative expense claim, it may, upon notice and a hearing, incur debt: (i) secured by a first lien on unencumbered property pursuant to Section 364(c)(2) of the Bankruptcy Code, or (ii) secured by a junior lien on encumbered property pursuant to Section 364(c)(3)

of the Code. The option described in clause (i) is the one generally used in pure postpetition financing situations where the DIP has substantial unencumbered assets such as accounts receivable generated postpetition.

*Borrowing with a first lien on collateral subject to prior encumbrances* — Generally, a prudent lender will be unwilling to extend financing to a DIP unless its loans are secured by a first-priority lien on substantially all of the DIP’s assets. When a significant portion of the DIP’s assets are subject to pre-existing (usually prepetition liens), this goal can be accomplished in one of three ways.

Junior lien pursuant to section 364(c) plus subordination agreement with senior secured creditor: First, the lender can, on occasion, obtain a junior lien on the DIP’s encumbered assets pursuant to Section 364(c)(3) and combine that lien with a subordination agreement from the senior lienholder to obtain a senior lien on previously encumbered property of the DIP. Given the difficulty of obtaining a “priming lien” or “superpriority lien” under Section 364(d) of the Bankruptcy Code, this method should be used to obtain a senior lien on encumbered property whenever possible.

The “super-priority lien” or “priming lien” of Section 364(d): Second, the DIP, in certain circumstances, may be able to grant the lender a priming lien on previously encumbered property. This superpriority lien of Section 364(d) should not be confused with the superpriority *claim* of Section 364(c)(1). To “prime” a senior secured creditor without its consent, the DIP must prove that (i) all other types of financing (e.g., financing secured by liens on unencumbered property) are unavailable and (ii) the interest of the primed creditor in the collateral at issue will be “adequately protected” by, for example, periodic cash payments, replacement liens, an equity cushion, or otherwise. Because it is extremely difficult to prove such adequate protection, unless the pre-existing secured creditor is hugely oversecured, priming liens are rarely obtained and will almost always involve a hotly contested, expensive and time-consuming court battle.

Paying senior lienholders with loan proceeds: Third, the DIP may consider using the initial advances under a pure postpetition loan facility to pay the secured claim of a prepetition lender in full in order to enable the new lender to acquire a first (and only) lien on the DIP’s assets. Because payment of prepetition secured claims cannot generally be seen as necessary to prevent immediate and irreparable harm to the DIP’s estate, the pure postpetition lender should usually agree to finance such payments only pursuant to a *final* financing order. Also, the final financing order should explicitly authorize the use of advances for this purpose because the DIP cannot pay any prepetition claims without court order. Finally, because a party objecting to the use of postpetition advances to satisfy prepetition secured claims may challenge the payments as improper on appeal, the lender should require that such payments can only be made

after the financing order has become *nonappealable* as well as final.

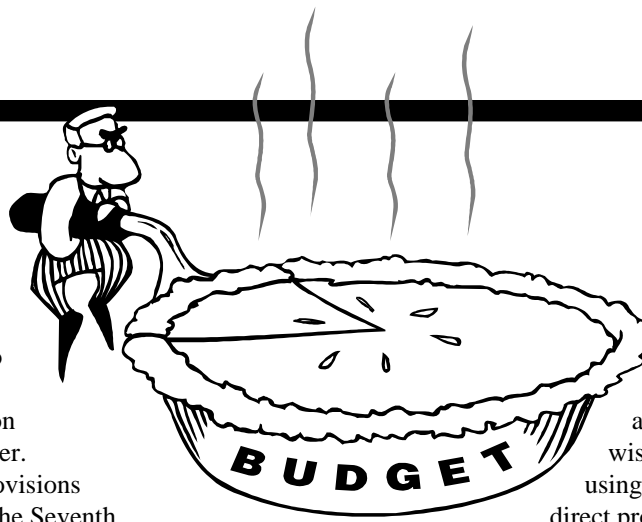
### Automatic perfection of liens

The financing order generally provides that all liens granted to the lender shall be perfected without any further notice, action or filing by the lender whatsoever. Such “automatic perfection” provisions were upheld as enforceable by the Seventh Circuit in *Small v. Beverly Bank*, 936 F.2d 945 (7th Cir. 1991), notwithstanding the failure of the secured creditor to perfect its lien under state law by filing a financing statement. It has also been held, however, that the dismissal of a bankruptcy case may terminate the effectiveness of liens granted to a creditor pursuant to Section 364 of the Bankruptcy Code unless those liens have been specifically preserved pursuant to an order of the Bankruptcy Court. *Production Credit Association of the Midlands v. Farm & Town Industries, Inc.*, 518 N.W. 2d 339, 343-344 (Iowa) (1994). The Supreme Court of Iowa also held in the *Farm & Town Industries* case that the liens granted to the postpetition lender survived the dismissal of the bankruptcy case because the lender had taken the necessary steps to perfect its postpetition lien under state law. *Id.* at 344. Accordingly, any lender extending postpetition credit to a DIP should file or record any documents necessary to perfect its liens under applicable state law to insure the survival of those liens in the event of a dismissal of the bankruptcy case.

### Special provisions of the pure postpetition financing order

The following provisions should be incorporated into an interim or final financing order authorizing pure postpetition financing.

*Special bankruptcy rights and remedies following default* — Right to cease funding upon notice of default and prospective or automatic relief from the automatic stay: The financing order should provide that, notwithstanding any cure periods contained in the financing order or in the loan documents, the lender may immediately cease funding upon notice to the DIP of an event of default. The financing order should also vacate the automatic stay with respect to the lender so that upon a default or other termination of the loan facility the lender may exercise its rights and remedies, without first having to obtain relief from the automatic stay. The right to such prospective relief from the automatic stay is among the most important benefits of pure postpetition financing. As the price of obtaining such extraordinary relief, however, the lender must generally consent to a reasonable period, usually five to ten business days, during which the DIP can either cure defaults or seek to convince



the court that no defaults exist. Bar on non-consensual use of cash collateral: Once a pure postpetition lender extends secured financing to the DIP, the lender will have an interest in the DIP’s cash collateral. If the lender ceases financing for any reason, the DIP is likely to wish to continue its operations by using such cash collateral. Absent a direct prohibition of the DIP’s use of such

cash collateral, Sections 363(c)(2) and (e) of the Bankruptcy Code would enable the DIP to use such cash collateral upon a showing of adequate protection of the lender’s interest therein. Accordingly, the prudent pure postpetition lender will try to use the financing order to bar the DIP from using cash collateral before the lender’s claim has been paid in full. Barring the DIP’s subsequent use of cash collateral is another of the most important benefits of pure postpetition financing, and though it will usually be challenged by the creditors’ committee during the negotiation of the final financing order, we generally believe that such a provision is a “must have.”

### Limitation or elimination of carve-outs

Because the superpriority claim and the liens granted to the lender pursuant to the financing order will often preclude or significantly reduce the possibility of payment of professionals’ fees in the event of a liquidation, the DIP, and especially the creditors’ committee, almost always attempt to negotiate a carve-out from the lender’s lien and superpriority claim for the payment of professionals’ fees. In the conventional situation where the prepetition lender extends postpetition financing to the DIP, such carve-outs have become extremely common because of the refusal of an increasing number of bankruptcy judges to enter financing orders without such carve-out provisions. See e.g., *In re Ames Dep’t Stores, Inc.*, 115 B.R. 34, 38 (Bankr. S.D.N.Y. 1990) (carve-out for professionals’ fees is necessary to preserve adversary process). The prepetition lender will often consent to some form of a carve-out as the price of obtaining the entry of a consensual financing order rather than running the dual risk of alienating the bankruptcy judge and suffering the entry of a nonconsensual cash collateral order over its objection. Because the pure postpetition lender has no interest in cash collateral prior to the time it extends financing pursuant to the financing order, the pure postpetition lender has substantial walk-away leverage to resist the imposition of a carve-out for professional fees. Accordingly, the postpetition lender should rarely consent to a carve-out. However, if the lender does consent to a carve-out, the financing order should limit both its amount, and the conditions under which the carve-out becomes effective, as much as possible.

## **Liens on avoidance actions**

The pure postpetition lender should consider taking liens upon all bankruptcy avoidance actions and the proceeds thereof, including actions to avoid fraudulent conveyances and voidable preferences. The creditors' committee, however, will almost never consent to such liens. While some success has been achieved in obtaining a lien on avoidance actions and proceeds of avoidance actions over the creditors' committee's objection, some courts have held that the avoidance actions themselves are nonassignable. See e.g., *In re North Atlantic Millwork Corp.*, 155 B.R. 271, 281 (Bankr. D. Mass. 1993); *In re Texas Gen. Petr. Corp.*, 58 B.R. 357, 358 (Bankr. S.D. Tex. 1986); *In re Sun Island Foods*, 125 B.R. 615, 618 (Bankr. D. Hawaii 1991). The court in *North Atlantic Millwork* held that, although a lender lacked standing to bring avoidance actions, the lender, nonetheless, held a lien on avoidance action recoveries; however, other courts which hold that avoidance actions are nonassignable may also hold that the proceeds of avoidance actions are also nonassignable. See e.g., *Sun Island Foods*, 125 B.R. at 619 ("... it is illogical to allow a secured creditor to attach the proceeds of recoveries, while at the same time preventing it from compelling a trustee to pursue a preference action."); *In re Integrated Testing Products Corp.*, 69 B.R. 901, 905 (D.N.J. 1987) (prepetition secured creditor was not entitled to preference proceeds to the detriment of the estate as a whole even if preference proceeds themselves might originally have been subject to the secured creditor's prepetition security interest). In deciding whether to go forward without a lien on avoidance actions, the lender should remember that a lien upon avoidance actions or proceeds of avoidance actions will generally be important only to it in the event of a liquidation following an unsuccessful attempt to reorganize.

## **Requirement that the DIP use all of its available cash before borrowing**

The pure postpetition lender may wish to have the financing order require the DIP to use all of its available cash on hand before it can borrow pursuant to the financing order. This requirement is primarily found in a window-dressing situation or in one where the DIP has a great deal of cash on hand at the commencement of the case. This requirement will both minimize the lender's exposure and prevent the DIP from creating a slush fund that it might try to use to continue its operations following its default and acceleration of the loan or following the termination of the loan facility for any other reason. This requirement is particularly beneficial to the lender when combined with unused line fees. Finally, when the postpetition lender is also a depositor, both the commitment letter and the financing order should require the DIP to maintain as many of its accounts as possible at the lender institution. The financing order, of course, should also require the DIP to remit all collections and other proceeds of collateral to the lender for application

to any outstanding indebtedness with the excess proceeds to be remitted to the DIP only if and when there is no outstanding loan balance.

## **Precluding charges against the collateral**

Section 506(c) of the Bankruptcy Code permits the DIP or a trustee to charge the lender's collateral for "the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to [the lender]." The DIP's or the trustee's counsel will often attempt to use Section 506(c) to recover professionals' fees when unencumbered estate property is insufficient to result in the payment of such fees in full. While bankruptcy judges are often reluctant to enter financing orders which strip the DIP of the statutory protections of Section 506(c), the pure postpetition lender is in a much stronger position to compel the entry of a financing order barring the use of Section 506(c) against it. It has been held, however, that financing order provisions barring Section 506(c) charges are "against public policy and unenforceable *per se*." *In re Ridgeline Structures, Inc.*, 154 B.R. 831, 832 (Bankr. D.N.H. 1993).

## **Protection of the lender if the final financing order is appealed**

Section 364(e) of the Bankruptcy Code. This section provides that "[t]he reversal or modification on appeal of [a financing order] does not affect the validity of any debt . . . incurred, or any priority or lien . . . granted [pursuant to the financing order] to an entity that extended such credit in good faith, whether or not such entity knew of the pendency of the appeal, unless [the financing order was] stayed pending appeal."

## **Good Faith Requirement of Section 364(e)**

Because of the great importance of Section 364(e) to a lender who has acted in good faith, a properly drafted financing order should include an explicit finding of the lender's good faith. An implicit finding of "good faith" may not be good enough. See *In re Revco D.S., Inc.*, 901 F.2d 1359, 1366 (6th Cir. 1990) ("... an implicit finding of 'good faith' in a §364(e) context is insufficient and ... 'good faith' under that Section should not be presumed."). Bankruptcy Courts may require, and the lender should insist upon, testimony creating a factual record to support a finding of good faith.

## **Scope of protection of Section 364(e)**

At a minimum, if the lender has extended credit in good faith and the financing order is not stayed pending appeal, the lender's claim for payment of its postpetition loan and the liens and priorities granted to it pursuant to the financing order should not be disturbed on appeal. The other rights and remedies given to the lender in the financing order, however, such as the prospective lifting of the automatic stay and the bar on the DIP's nonconsensual use of cash collateral, are outside of

the literal language of Section 364(e). As a result, such additional rights and remedies arguably may not be insulated from attack on appeal. Accordingly, the pure postpetition lender may wish to finance only pursuant to a final, *nonappealable* order whenever possible. In the alternative, the pure postpetition lender may require that any filing of an appeal of the final financing order will constitute an event of default.

### Mootness

If the appellant fails to obtain a stay of the financing order, the appeal will be dismissed as “moot” if actions have been taken pursuant to the financing order which render the court incapable of granting the appellant any effectual relief. See, e.g., *Church of Scientology of California v. United States*, 113 S.Ct. 447, 449, 121 L.Ed.2d 313 (1992) (occurrence of an event while appeal is pending that makes it impossible for the court to grant any effectual relief on appeal to the prevailing party mandates dismissal of the appeal as moot). Whether the appellant’s failure to obtain a stay of the financing order moots the entire appeal may well depend upon the extent to which a postpetition loan has actually been funded. In *In re Swedeland Development Group, Inc.*, 16 F.3d 552, 560-561 (3d Cir. 1994), the Third Circuit held that an appeal of a financing order was moot when all advances contemplated by the financing order had been disbursed by the lender prior to the ruling on the appeal because the court could not grant effectual relief to the appellant without denying the lender the protections of Section 364(e). The Third Circuit, however, also held that an appeal of a financing order was not moot when some, but not all, of the contemplated disbursements had been made. Although in this situation the Third Circuit recognized that the lender was entitled to the protections of Section 364(e) with respect to all funds advanced prior to the ruling on appeal, the Third Circuit also reasoned that some effective relief nonetheless could be granted to the appellant simply by prohibiting the lender from making further advances. If the reasoning of the *Swedeland* court is adopted, a lender could find itself in the position of having to cease funding following an adverse ruling on appeal, although it would receive the protections of Section 364(e) for all funds actually advanced in good faith prior to the adverse ruling. This risk is another reason to consider the advisability of financing only pursuant to a final, nonappealable financing order.

### Standard loan document provisions

The pure postpetition lender should be able to adopt its form loan documents to satisfy the requirements of pure



postpetition lending. Advance rates, interest rates, covenants, reporting requirements, default provisions and remedy provisions will be similar, if not identical, to those appropriate in comparable loans outside of bankruptcy. Obviously, certain provisions are inapplicable in the bankruptcy context; for example, default

provisions triggered by the borrower’s insolvency or filing of a bankruptcy petition are irrelevant. Covenants that the DIP is not in breach of any material contracts and that no unsatisfied judgments have been entered against it are also of less importance because creditors are prevented by the automatic stay from enforcing prepetition claims and judgments against the DIP.

### Special “bankruptcy” events of default

The prudent lender, however, should characterize the following possible bankruptcy events as either events of defaults or events which will automatically trigger the termination of the loan facility:

*Appointment of a Chapter 11 trustee* — This provision parallels, and might actually be subsumed within, a traditional “change of control default.”

*Conversion to Chapter 7 or dismissal of the case* — Following a conversion of the case to Chapter 7, the lender will generally want the option of exercising its rights and remedies to realize upon the value of its collateral without leaving the liquidation of its collateral under the control of a Chapter 7 trustee. If the lender wishes to use the Chapter 7 trustee to liquidate its collateral — the trustee, for example, can often use the bankruptcy court as a single forum for the collection of accounts receivable collateral — the lender will then be able to negotiate with the trustee from a position of strength.

*Breach of the financing order* — The loan documents should specifically provide that any breach of the terms of the financing order shall constitute an event of default under the loan documents.

### Budget for the DIP’s operations

Finally, the lender may wish to limit the purposes for which the DIP can use advances by requiring an expense or operating budget as part of the financing order. The risks of lender liability for “controlling” the DIP’s business are likely to be greatly reduced when the lender exercises such indirect “control” pursuant to a budget which has been negotiated prior to the entry of the financing order and incorporated into the financing order. Any amendments to such budgets, however, will require approval of the Bankruptcy Court, after notice and a hearing. ▲