

## **Best Practices Series – Distressed Debt:** **Debtor-in-Possession Financing**

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### Part 1: The Basics

1. What is Debtor-in-Possession (DIP) Financing?
  - a. Lender loans new money to the Debtor/Borrower
  - b. Lender is commonly given various liens or protections for the loan
  - c. DIP financing can be obtained in Chapters 11, 12 and 13
2. Why Should Lenders Consider DIP Financing?
  - a. Chapter 11 can actually benefit a secured lender if the debtor/borrower can shed significant unsecured debt
  - b. DIP financing provides a means for “loan-to-own” lenders to more effectively accomplish their objectives
3. Academic Research Validates the Benefits of DIP Financing
  - a. Companies that obtain DIP financing are more likely to emerge from Chapter 11 than companies that do not obtain DIP financing.<sup>2</sup>
  - b. The duration of the bankruptcy is shorter when the bankruptcy DIP lender is the same lender that did the pre-petition lending.<sup>3</sup>
  - c. Smaller debtors are more likely to obtain DIP financing from their pre-petition lenders.<sup>4</sup>

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<sup>2</sup> Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 259–280; see also Carapeto, Maria, 1999, “Does Debtor-in-Possession Financing Add Value?” IFA Working Paper No. 294–1999, Cass Business School Research Paper, England.

<sup>3</sup> Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 259–280.

<sup>4</sup> Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 262.

- d. Bankruptcy proceedings (both reorganizations and liquidations) tend to be shorter for a company that has DIP financing.<sup>5</sup>
  - e. DIP financing provides an effective means for doing a prompt turnaround in bankruptcy thereby putting the borrower on much better financial footing.<sup>6</sup>
  - f. Larger companies are more prone to obtaining DIP financing.<sup>7</sup>
4. Post-petition Effect of a Pre-Petition Security Interest
- a. General Rule:
    - i. “[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.” 11 U.S.C. § 552(a).
  - b. Exception:
    - i. “[I]f the [pre-petition] security interest...extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case...” 11 U.S.C. § 552(b).
5. Debtor’s Possible Cash Sources in Bankruptcy
- a. Use of existing cash collateral
  - b. Post-petition financing (and no pre-petition loan)
  - c. Post-petition financing with “roll-over” agreement
6. Cash Collateral & Adequate Protection
- a. What is cash collateral?
  - b. Cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired...and includes the proceeds, products, offspring, rents, or profits of property...” 11 U.S.C. § 363(a).
7. General Rule for Cash Collateral:
- a. The debtor can do normal, ordinary course transactions without court approval, BUT
  - b. Debtor cannot use cash collateral unless lender consents OR
  - c. The Court authorizes use of cash collateral
8. Best Practices to Protect Cash Collateral:
- a. If no agreement regarding use of cash collateral exists, lender should immediately file a “Notice of Non-Consent to Use of Cash Collateral” at the outset of the case.
  - b. Absent an agreement with the borrower, the Lender should freeze bank accounts upon learning of the filing

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<sup>5</sup> Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 259–280.

<sup>6</sup> Given these findings it is not a surprise that larger companies are more prone to obtaining DIP financing. Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 261.

<sup>7</sup> Dahiya, Sandeep, Kose John, Manju Puri and Gabriel Ramirez, 2003, “Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence,” *Journal of Financial Economics*, 69, 261.

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- c. Immediately seek adequate protection
  - i. Lenders are only entitled to adequate protection beginning on the date they seek it
  - ii. A common practice is to file a motion for adequate protection or, alternatively, motion for relief from the automatic stay

## 9. The Different “Tiers” of § 364 Post-Petition Financing

Tier	Type	Lender Protection
1	Unsecured	Administrative expense § 364(a) and (b)
2	Unsecured	Super-priority administrative expense § 364(c)(1)
3	Secured	Lien on unencumbered estate property § 364(c)(2)
4	Secured	Junior lien on estate property § 364(c)(3)
5	Secured	Super-priority priming lien § 364(d)

*Note: To move to a higher tier a debtor must show credit is not available at a lower tier.*

## 10. Priming Liens

- a. Debtor must show it is unable to obtain credit at a lower tier, and
- b. Adequate protection must be granted to the secured lenders being primed.
- c. Debtor has the burden of proving adequate protection.
- d. It is difficult to obtain a priming lien because debtors typically don’t have assets with large equity cushion

## 11. Rollover of Pre-petition Secured Debt

- a. General Rule: Post-petition loan secured by post-petition assets while pre-petition loan secured by pre-petition assets
- b. As a practical matter, it is sometimes difficult to determine whether certain assets (e.g., accounts receivable, inventory, etc.) are pre- or post-petition assets.
- c. Pre-petition debt can be crammed down but post-petition debt cannot be crammed down in a plan of reorganization

## 12. Rollover—Getting the Best of Both Worlds

- a. Under a rollover, all payments received are applied to the pre-petition debt until paid in full.
- b. This replaces the pre-petition secured debt with the post-petition secured debt which has the super-priority administrative expense status and possibly a priming lien
- c. Cure pre-petition flaws in the loan documents or perfection
- d. Cure a pre-petition under-secured position
- e. Practically prohibits the debtor from using cram down provisions of Chapter 11
- f. A Rollover (or roll-up) can be done as a lump sum or on a creeping basis (i.e., revolver where old collections paydown debt and new advances are post-petition).

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- g. Roll-up risk: U.S. Trustee may take the position that the payments on the pre-petition debt are estate “disbursements” and therefore subject to U.S. Trustee fees.

## Part 2: Key Provisions in DIP Financing Agreements & DIP Orders

- 13. Admissions in DIP Agreements and Orders
- 14. Post-Petition Liens
  - a. Scope of lien
  - b. Cross-collateralization
- 15. Perfection of Liens
- 16. Basic terms (loan amount, rate, fees, etc.)
- 17. Milestones
- 18. Limitations on use of funds (i.e., can only be used for some purposes and not for others).
- 19. Budgets
- 20. Cross-collateralization provisions
- 21. Default Provisions & Remedies
- 22. Carve-outs for professional fees
- 23. Limitations on future borrowings
- 24. Releases and Waivers
  - a. Waiver of claims
  - b. Waiver of right to contest secured status of lender’s loans
  - c. Waiver of 11 U.S.C. § 506(c) surcharge right
- 25. Lien on Chapter 5 avoidance (clawback) actions

## Part 3: Best Practices & Common Challenges

- 26. Timing is Critical – Start DIP Negotiations *Before* Bankruptcy
- 27. Work with Debtor to insure it can meet its evidentiary burdens showing no other more favorable financing was available
- 28. Post-petition Liens on Bankruptcy Avoidance Actions
  - a. What are Chapter 5 Avoidance Claims?
    - i. “Strong-arm”/lien avoidance claims (§§ 544 and 545)
    - ii. Preferential transfers (§ 547)
    - iii. Fraudulent conveyances (§§ 544 and 548)
    - iv. Improper post-petition transfers (§ 549)
  - b. Chapter 5 Avoidance Claims are unencumbered property of the estate
  - c. Only the debtor or trustee may pursue avoidance actions
  - d. Secured lender will get a lien on proceeds of avoidance actions
- 29. Common Objections to Liens on Bankruptcy Avoidance Actions
  - a. Avoidance actions are for the benefit of unsecured creditors;
  - b. Lien on avoidance actions only benefits the secured lender – not the estate
- 30. “Challenge” Periods – a period of time where creditors may challenge the lender’s lien
- 31. Common Objections to DIP Financing (Including Rollovers)
  - a. Some bankruptcy judges may not allow it

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- b. Other creditors will object – especially if the lender is using a rollover to cure loan defects or an under-collateralized position
- c. Objection that it creates a *sub rosa* plan
- d. Challenge periods
- e. Priming lien disputes
- f. Carveouts for professional fees

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