First Day, Last Chance: The New Trend Of DIP Financing In Chapter 11

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In the not too distant past, the prospect of filing for Chapter 11 under the US Bankruptcy Code offered many companies a meaningful opportunity to reconfigure their capital structures and shed economically unfavourable contracts in an effort to reorganise their businesses. Essential to this process was the Chapter 11 debtor's ability to obtain debtor-in-possession ("DIP") financing that would provide the debtor with the necessary liquidity to operate in bankruptcy on a long-term basis (sometimes for several years or more) while the company pursued a strategy to exit from Chapter 11 under a plan of reorganisation.

Today, however, long term DIP financing facilities are scarcely available, and plans of reorganisation are the exception in Chapter 11. Rather, the growing trend is that the debtor's existing secured lenders are providing DIP financing on the 'first day' of the bankruptcy case to facilitate the liquidation of their collateral. These 'defensive' or 'liquidating' DIP credit facilities are short-term loan commitments (e.g., six months) that usually run commensurate with the projected collateral liquidation receipts necessary to fully repay the loan. As a result of this trend, the 'first day' hearing of the Chapter 11 case is arguably the most critical day of the case, as approval of these defensive DIP credit facilities sets forth the framework for the orderly liquidation of the debtor's assets.

In addition to the current economic recession and credit crisis of 2008, several factors have contributed to the growing trend of first day liquidating DIP financing facilities. First, the sweeping changes made to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 have reduced the amount of time during which the debtor can enjoy the uninterrupted benefits of Chapter 11, while simultaneously they have made Chapter 11 a more expensive process to administer. For example, the debtor's time to assume or reject its non-residential real estate leasehold interests is now limited to a maximum amount of 210 days from the filing date of the Chapter 11 case, unless the landlord consents to further time (previously, the bankruptcy court had discretion to extend this timeframe through to plan confirmation). In addition, the amendments created an entirely new class of administrative expense claims (which must be paid upon consummation of a plan of reorganisation) by granting all pre-Chapter 11 trade creditors who deliver goods to the debtor within 20 days of the Chapter 11 filing an administrative expense claim for the amounts owing to such vendors for the delivered goods.

Another factor contributing to this trend is that most debtors entering into Chapter 11 today have highly leveraged capital structures attributable to the 'easy' credit environment that prevailed over the last several years. In many cases, the debtor's existing secured lenders are under-secured in the aggregate, and the debtor has little or no availability under its existing credit lines before it limps into Chapter 11. Without additional capital provided by equity holders or sponsor groups, the debtor has no unencumbered collateral to offer a potential new DIP lender to refinance the debtor's existing secured debt and provide additional availability to fund all Chapter 11 expenses.

A defensive DIP financing lender will usually require certain sale or liquidation covenants by the debtor that will dictate the course and timing of the liquidation of the debtor's assets. For example, the DIP lender may require sale 'milestone' dates by which the debtor must sell its business lines and/or assets, strict compliance with a wind-down cash flow forecast or 'budget' and/or immediate retention of an investment banker or liquidation consultant to market and/or sell the debtor's assets on a specified timetable. Compliance with these covenants will require the debtor to seek entry of additional 'first day' orders by the bankruptcy court to satisfy these financing requirements.

As required by applicable bankruptcy rules, the 'first day' orders approving these liquidating DIP financing facilities and related relief are 'interim' orders, i.e., effective for a limited period of time pending the entry of 'final' orders. While this procedure gives other interested parties in the case the opportunity to oppose the DIP financing terms at the 'final' hearing (usually taking place several weeks after the first day hearing), bankruptcy courts rarely reverse course from the direction set by these first day orders. The liquidation of the debtor's assets pursuant to these orders will have been in effect for at least several weeks. Moreover, the Bankruptcy Code protects the DIP lender for all extensions of credit made in reliance on the 'interim' financing order.

Given the downturn of the US economy and current framework of the Bankruptcy Code, it is unlikely that the emerging trend of first day liquidating DIP financing facilities will subside anytime in the near future.

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