DEBTOR IN POSSESSION FINANCING STRUCTURES
AND "PRIMING" FINANCING — A BRIEF SUMMARY

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I.
INTRODUCTION

Bankruptcy Code section 364 provides that a trustee or debtor in possession (see 11 U.S.C. § 1107(a)) authorized to operate the business may obtain financing in or outside of the ordinary course of business. Bankruptcy Code section 364(a) allows the debtor to obtain unsecured credit and incur unsecured debt in the ordinary course of business, whereas section 364(b) allows the debtor to obtain unsecured credit and incur unsecured debt outside of the ordinary course of business, only after notice and a hearing. Id. §§ 364(a), (b).

If the debtor is unable to obtain unsecured credit solely based upon the award of an administrative expense under section 503(b)(1), the Bankruptcy Code authorizes the debtor to obtain credit or to incur debt that has priority over administrative expenses of the kind specified in Bankruptcy Code sections 503(b) or 507(b) (a so-called "super" administrative priority). Id. § 364(c)(1). In addition, after notice and a hearing, the debtor may obtain credit or incur debt secured by a senior lien on property of the estate (a so-called "priming" lien), if the debtor in possession is unable to obtain such credit otherwise and "there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted." Id. § 364(d)(1)(B).

II.
DISCUSSION.

A. Debtor in Possession Financing Structures.

Although each debtor in possession financing transaction is to some degree unique, virtually every debtor in possession financing is structured in one of three general ways:

1. Continued Use of Cash Collateral with Debtor in Possession Overlay.

Under this structure, the debtor continues to use cash collateral to meet operating needs and pay expenses, but also obtains financing (from the prepetition lender or a "priming" lender) which is available for borrowing under an availability formula or other basis. The debtor
in possession financing is in the nature of an "over advance" facility, which the debtor may access to the extent cash collateral is inadequate to cover the debtor's operating needs; the facility is secured by a senior lien and typically is given super administrative priority. A junior lien (and section 507(b) priority) is awarded to the prepetition lender resulting from the debtor's use of cash collateral and the financing. Cash collateral is not applied to pay the indebtedness owing to the prepetition lender. Rather, cash collateral is used to repay advances and meet operating needs. This structure is the most advantageous to the debtor (and least advantageous to the prepetition lender), because neither the borrowing proceeds nor cash collateral is applied to repay prepetition indebtedness, the debtor preserves its right to restructure the prepetition indebtedness, and the estate only becomes liable under the debtor in possession facility to the extent the facility is drawn.

Debtor in possession financings of this structure are typical where the debtor obtains priming financing, not all of the prepetition lenders are prepared to advance funds postpetition (such that some, but not all, prepetition lenders in effect "prime" the prepetition group), or where the debtor is in a strong bargaining position vis-à-vis its prepetition lenders. See Frederick's of Hollywood Motion, attached hereto as Exhibit 1.


Under this structure, the prepetition lender provides debtor in possession financing (typically under an amended credit agreement) secured by a senior lien, with super administrative priority, and all cash collateral generated from operations is transferred to the prepetition lender, which in turn advances funds to the debtor under an availability formula or other basis. To the extent the debtor borrows funds postpetition, postpetition (and super administrative priority) indebtedness is created in favor of the prepetition lender. Postpetition cash and proceeds from operations, however, are applied first to repay postpetition advances;
only after postpetition advances are repaid are funds applied against prepetition indebtedness. Thus, prepetition indebtedness is satisfied only to the extent postpetition revenues exceed postpetition advances.

This structure is somewhat less favorable to the debtor (and more favorable to the prepetition lender) than the first structure. On the one hand, postpetition revenues in excess of postpetition advances are applied to prepetition indebtedness, thereby satisfying a portion of the prepetition lender's claim during the case. On the other hand, postpetition revenues are first applied to postpetition advances, thereby limiting the extent to which prepetition indebtedness to the lender is satisfied during the case; the balance of the prepetition indebtedness may be restructured under a plan.

3. Partial or Complete Rollover of Prepetition Indebtedness and Substantial Repayment of Prepetition Debt.

The final structure is the least favorable to the debtor (and the most favorable to the prepetition lender). Under this structure, the prepetition lender provides debtor in possession financing (typically under an amended credit agreement) secured by a senior lien, with super administrative priority, and either (i) a portion of the debtor in possession financing is immediately used to retire the prepetition debt or (ii) cash collateral generated from postpetition operations is transferred to the prepetition lender and applied against prepetition indebtedness owing to the lender. Under the scenario described in (ii) above, as the debtor generates postpetition cash and proceeds, slowly but surely (sometimes not even very slowly), the prepetition indebtedness is reduced (and, in effect, transformed into postpetition indebtedness that cannot be restructured under a plan of reorganization). As a practical matter, any ability of the debtor or creditors to challenge the prepetition lender's lien is lost as the prepetition indebtedness is satisfied and postpetition indebtedness is created.

Debtor in possession financings of this kind are common where the debtor cannot continue to operate without new money and/or cannot furnish adequate protection to the prepetition lender.
B. **Issues Negotiated in Connection with Debtor in Possession Financing.**

Regardless of how the specific debtor in possession financing transaction is structured, a host of legal and economic issues typically are negotiated between the debtor and a prospective lender (often on an expedited basis) including:

(a) economic issues, such as availability, pricing, payment of facility or unused line fees;

(b) the duration of the facility;

(c) the extent to which the debtor may use borrowing proceeds without restrictions (such as to furnish adequate protection to junior creditors, pay specified prepetition debt, etc.);

(d) the amount of any "carve-out" for debtor or committee professional fees;

(e) the nature and amount of collateral to secure the postpetition indebtedness (including whether the postpetition lien and administrative priority extends to avoidance actions);

(f) the conditions under which a lender will be required to make advances (including whether the lender will fund based upon an appealed or unstayed order);

(g) the lender's ability to assign or participate without the borrower's consent; and

(h) where the prepetition lender furnishes the debtor in possession financing, the extent to which the lender will obtain waivers of, or limitations on, rights to challenge prepetition liens or assert claims against the prepetition lenders.

C. ** Priming Loans.**

The imposition of a lien senior to a pre-existing lien on property of the estate in favor of a new lender is known as a "priming lien." The Bankruptcy Code establishes relatively few requirements for the obtaining of priming financing. First, the debtor must establish that it is otherwise unable to obtain such credit. This requirement typically is not difficult to meet (although it is sometimes ignored, to the debtor's detriment, see, e.g., In re Executive Air Services, 62 B.R. 474, 477 (D. Utah 1986)). Next, the requested priming lien can only be
obtained after notice and a hearing. Once again, subject to compliance with the requirements of Bankruptcy Rule 4001(b) and (c), this requirement is not particularly difficult to meet.

By far the most important and difficult requirement in connection with a priming lien is the establishment of adequate protection, which is the debtor's burden. 11 U.S.C. § 364(d)(2). Bankruptcy Code section 361 provides that adequate protection is required to the extent the debtor's "use, sale, lease or grant results in a decrease in the value of such entity's interest in property." 11 U.S.C. § 361(1), (2), (3). Generally speaking, adequate protection protects a pre-existing lienholder against a decrease in the value of its collateral. See, e.g., In re Planned Systems, Inc., 78 B.R. 852, 861-62 (Bankr. S.D. Ohio 1987). This standard applies equally with respect to a proposed "priming" financing under Bankruptcy Code section 364(d)(1)(B). See, e.g., In re Hubbard Power & Light, 202 B.R. 680, 685 (Bankr. E.D.N.Y. 1996) ("The goal of adequate protection for purposes of the provision entitling a debtor to obtain financing secured by liens senior to all other interests is to safeguard the secured creditor from diminution in the value of its interests."); In re Aqua Assoc., 123 B.R. 192, 196 (Bankr. E.D. Pa. 1991); In re Beker Ind. Corp., 58 B.R. 725, 741-42 (Bankr. S.D.N.Y. 1986).

The most common way to establish adequate protection is to demonstrate the existence of an "equity cushion." See, e.g., In re C.B.G Ltd., 150 B.R. 570, 572-73 (Bankr. M.D. Pa. 1992) (16% equity cushion not adequate to support priming lien); In re Plabell Rubber Products, Inc., 137 B.R. 897, 899-901 (Bankr. N.D. Ohio 1992) (extensive equity cushion adequate). For example, in In re Dunes Casino Hotel, 69 B.R. 784 (Bankr. D.N.J. 1986), the debtor proposed to incur $700,000 in priming indebtedness, whereas the prepetition debt against the subject property was $17.5 million and the property was valued at $26.2 million. The bankruptcy court found the equity cushion more than adequate under the circumstances.

Because, by definition, a priming lien pushes the pre-existing lender down in the order of lien priority, establishing adequate protection is extraordinarily difficult (but not impossible) where the pre-existing lender is undersecured. Whether or not the debtor tries to establish that the prepetition lender is oversecured, obtaining priming financing is particularly
difficult with respect to "start-up" enterprises. Courts have generally rejected efforts by debtors to prime a prepetition lender as to a start-up development or business, absent tangible evidence that the financing will increase value. See, In re 495 Cent. Park Ave Corp., 136 B.R. 626, 630-31 (Bankr. S.D.N.Y. 1992) (undisputed expert evidence showed that new financing would enhance value in excess of amount incurred). See, e.g., Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group), 16 F.3d 552 (3d Cir. 1994) (debtor attempted to obtain financing to help debtor build and develop a golf course and accompanying residential project); In re Mosello, 195 B.R. 277 (Bankr. S.D.N.Y. 1996) (involving debtor's proposed development of 17 acres of land which the debtor "hoped" to subdivide into building lots); In re Plabell Rubber Prods., Inc., 137 B.R. 897 (Bankr. N.D. Ohio 1992) (debtor failed to present projections or other documentation);

On the other hand, where the debtor operates a mature (but perhaps over-leveraged) business and can present realistic projections establishing enhanced value resulting from the priming financing, the debtor may be in a better position to establish adequate protection. See, e.g., Bray v. Shenandoah Fed. Sav. & Loan Ass'n (In re Snowshoe Co.), 789 F.2d 1085, 1087-90 (4th Cir. 1986) (noting the importance of projections prepared in good faith with expert assistance). The key issue is whether incurring the additional indebtedness will correspondingly increase the debtor's value. See generally id. For example, in the Frederick's cases, the debtors successfully showed that, whether or not the prepetition lender was oversecured, the priming financing likely would increase the aggregate amount of the debtor's inventory, receivables and cash balances by an amount in excess of the anticipated priming indebtedness incurred. The same result was achieved in the Sun World cases.