Boyd & Hembree LLP

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| To: | William Nash, GC of Vandelay Industries |
| From: | Kevin Hembree |
| Date: | October 31, 2014 |
| re: | Use of Cash Collateral and “DIP” Financing  |
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 Upon filing for bankruptcy, a debtor who has granted liens in any “cash collateral” may not use that cash collateral without approval of the bankruptcy court or the consent of the lienholder. Cash collateral is both cash that a debtor holds when it files for bankruptcy and any subsequent cash that is generated from the proceeds of a lienholder’s collateral (e.g., accounts receivable).

 The limitation on a debtor’s ability to use cash collateral is critical and, if not resolved, may thwart a debtor’s attempts to reorganize. Ordinarily, a debtor will negotiate with its lienholders prior to filing for bankruptcy to come to agreeable terms and conditions under which the debtor may continue to use cash collateral. Typically a debtor may agree to make periodic payments to its lienholder, grant “replacement liens” in newly generated accounts, agree to limit its use of cash in accordance with a budget, or only use cash through a certain period in time, among other things.

 Absent agreement with a debtor’s lienholders on cash collateral use, the only way a debtor may use cash collateral is with approval by the bankruptcy court (and potentially over the objection of the lienholder). A bankruptcy court will only permit the debtor to use cash over the objection of the lienholder if the debtor can show that the lienholder is “adequately protected.” That is, in exchange for the continued use of the lienholder’s collateral (and the resulting diminution in value of that collateral from its use), the debtor must compensate the lienholder such that the lienholder is not made worse off by the use of its collateral during the course of the bankruptcy case. The form of compensation constituting “adequate protection” is flexible and may include periodic cash payments, replacement liens for the creditor, the presence of equity in the collateral, or anything else that provides the creditor with the “indubitable equivalent” of its interest in the debtor’s property. These restrictions are ultimately intended to ensure that the lienholder is not harmed by the delay caused by the bankruptcy and the debtor’s continued use of the lienholder’s collateral during the pendency of the bankruptcy case. Aside from cash, a lienholder may seek adequate protection payments for other collateral that may diminish during the pendency of the case.

A debtor’s cash collateral may be insufficient to continue to fund its operations in bankruptcy. For that reason, the Bankruptcy Code permits a debtor to borrow additional money to operate its business during the bankruptcy case, on either a secured or unsecured basis. The financing may be junior to, ratable with, or senior to existing financing. However, in order to obtain secured financing (of any kind), the debtor must show that it was unable to obtain unsecured financing. Further, if a debtor wants to obtain financing that is senior to or ratable with existing financing, it must show that it was unable to obtain either unsecured financing or financing secured by a junior lien and that the existing lienholder will be adequately protected in its interest in the debtor’s collateral.

Frequently a debtor’s pre-bankruptcy lender will also provide post-bankruptcy financing as well (to the extent financing is needed). There are a number of dynamics that drive this result. First, generally it is difficult for a debtor in bankruptcy to obtain any financing that is not secured (after all, the debtor is already in bankruptcy and therefore has shown itself not necessarily to be creditworthy). Second, a party providing new financing will ordinarily not agree to lend into a bankruptcy at a junior level to existing creditors. As a result, frequently the only realistic opportunity to obtain new financing is to grant senior liens in the debtor’s property. Most existing lenders will ordinarily vigorously contest such an effort (this is known as a “priming” fight). Furthermore, it may be difficult for a debtor to establish that the existing lender will continue to be adequately protected if it is placed into a junior position. And finally, throughout these disputes, the debtor may not have access to incremental financing or otherwise be permitted to use cash collateral. For all of these reasons, it is most common for debtors that need incremental bankruptcy financing to obtain that financing from its existing lender or lenders.