

## Current economy promises new risks in commercial bankruptcy filings (April 14, 2009)

Don't get caught by new gambits that reorganizing debtors may attempt

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As we move through this period of mounting financial distress, we expect to see an increase in bankruptcy cases filed by businesses. Those cases will be significantly different than the types of cases that we have seen in the past, however, and may present new and different challenges for bankers.

Here is a brief discussion of a few select issues.

### Non-consensual requests to use cash collateral

Over the last several years there has been a tremendous amount of cash available for debtor-in-possession financing in Chapter 11 cases. Either the existing lender was voluntarily making available new or additional credit, or a new lender was in the wings. This has suddenly changed. There is no liquidity or availability in the market, and if the lender is not willing to extend a "defensive DIP" (discussed below) then the debtor is going to have to attempt a non-consensual use of cash collateral.

To provide adequate protection to the creditor, the debtor must show the court that the debtor's cash and cash equivalents (such as proceeds from sales of assets) are encumbered in favor of the lender; that the debtor needs to use cash collateral to operate its business; and that the affected creditor's interests in its collateral can be "adequately protected."

Adequate protection means that the creditor will still realize the equivalent of its interest in the collateral the debtor proposes to use. This might be shown by the granting of a replacement lien (on post-petition inventory and accounts receivable, which might no longer be subject to an after-acquired property clause in the security agreement); by the existence of an equity cushion, which, after cost of collection, exceeds the diminution in the cash collateral; by the granting of a lien on previously unencumbered or under-encumbered property; or such other method that will protect the creditor other than the mere promise of an administrative expense priority claim for the diminution in value.

Now, in theory, let's say the debtor is operating at breakeven or better. After taking into account the expenses it is incurring to support its Chapter 11 proceedings, then a replacement lien in the new inventory, accounts receivable, and proceeds would suffice to provide adequate protection.

Of course, if that were true, either the debtor wouldn't need to be in Chapter 11, or if it had other reasons to be in Chapter 11, the lender would have consented to the use of cash collateral.

So, more often than not, when the debtor seeks non-consensual use of cash collateral, the debtor is not operating at break-even; it cannot pay its Chapter 11 professional expenses; and the collateral base is eroding.

The difficult issue is how much leeway a court will try to give a struggling debtor in these economic times, and how much risk is created for the lender as the economy itself may be causing further reductions in the value of the collateral pool.

Potential solution: Negotiate short-term cash collateral deals. It may be best, given these competing concerns and the bankruptcy court's inherent pro-reorganization bias, to negotiate short-term consensual cash collateral stipulations, with goals and milestones. In this way the parties can negotiate what constitutes "performance," how long the process will last, and the measures by which it will be determined that the lender's exposure has increased too much.

#### Defensive DIP and pre-petition roll up

Something new in the market today is the defensive debtor-in-possession loan. In this mechanism, one or more of the existing lenders (and frequently fewer than all) extend very expensive debtor-in-possession or DIP financing (frequently with rates and fees yielding over 22%).

DIP financings have very stringent requirements. They may mandate a sale-and-auction process or give the debtor a limited window to refinance, confirm a plan, or the like. Often second-lien lenders, unsecured creditors, or even first-lien lenders not included in the DIP financing try to object to some of the more onerous terms and conditions. This is especially true where the DIP lenders have existing loans predating the bankruptcy petition. They may try to roll up their pre-petition loans into the post-petition financing. This becomes a significant problem where other creditors believe they have not been given an adequate opportunity to look into all the facts and circumstances relating to those borrowings. In another scenario, other lenders who used to be *pari passu* (treated equally) now find themselves subordinated to those loans, including the roll up portion, because of the granting of a super priority priming lien.

[Editor's note: A priming lien is one granted to a new lender which puts that lender's claim ahead of those of pre-existing lenders. The bankruptcy law permits this change in lien priority when a debtor can establish that it would not otherwise be able to obtain fresh financing.]

Such problems are exacerbated by declining collateral values, a particularly likely scenario in our troubled economic times. A formerly *pari passu* lender may find itself wholly unsecured behind the claims of its formerly co-equal co-lenders.

Potential solution: Check your options. The advent of this new strategy should drive every banker to a closer examination of its co-lender agreements to determine whether it might be a victim of such strategy, or whether it can take advantage of such an opportunity.

#### Disappearing setoff rights

Lenders, especially those that are unsecured or find themselves under-secured, need to protect their right to exercise setoff rights against deposit accounts. If the debtor is proposing to use another bank's cash collateral or is proposing to obtain post-petition DIP financing, the setoff bank must act immediately to ensure that the priming or replacement liens to be granted do not prime the bank's setoff rights and if they do, must promptly object to preserve same.

The bank must also act vigilantly to ensure that the account is not drained in the ordinary course through the honoring of checks. A temporary freeze should be placed on the account and the bank should immediately move for relief from the automatic stay to exercise its setoff rights. Relief from the stay is absolutely necessary before those rights may be effectuated.

Potential solution: Watch out for early actions. The bank should also review other first-day motions, particularly those that might involve honoring checks, such as wage motions, to make sure the bank is not compelled to honor checks since that will reduce the cash available for set off.

#### Loss of excess letter-of-credit proceeds

If a bank has provided a letter of credit that the beneficiary draws down before the beneficiary's losses have been liquidated, the letter-of-credit bank needs to make sure that any future excess proceeds from the letter of credit draw come back to the bank and are not returned to the debtor if there is any chance the bank is under-secured or has no collateral.

Potential solution: Revisit your documentation. Bankers who issue letters of credit for distressed borrowers should consider revising forms and reimbursement agreements to eliminate this possibility.

While many issues in bankruptcy cases are familiar, these issues demonstrate that the emergence of a new issue is only limited by the creative thinking of the debtors and their lawyers. BJ

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