Businesses in financial distress find their sources of new funding shrink just when they need financing the most. A company’s ability to obtain new monies advanced from their current lender may be cut off, and they may also fall into default of their loan covenants.

For many distressed companies, there is hope for new financing. Using the United States Bankruptcy Courts, they can file for Chapter 11 bankruptcy protection. This will allow them to take advantage of Debtor-in-Possession (DIP) financing to help them reverse course, give them restructuring support and return to profitability.

Many lenders and other financing sources see Debtor in Possession financing as an attractive lending opportunity because of the special treatment that business bankruptcy loans receive under U.S. bankruptcy law. Under the law, DIP creditors are typically repaid before other creditors. In fact, many lenders will commit to a DIP Chapter 11 loan while they would not make a loan commitment to the same business in the absence of a bankruptcy filing.

What is the DIP Process?

In DIP restructuring finance, the assets pledged as collateral must be sufficient to cover the business bankruptcy loan or credit facility. Here’s how the DIP Chapter 11 financing process works:

When the company has located a lender willing to finance their turnaround, the company seeks court approval from the Bankruptcy Court. Typical DIP financing terms include a “first priority” security interest in the collateral, a market rate or even premium rate of interest, an approved budget, and other lender protections. Creditors may object to the loan if they feel it weakens their position. The Bankruptcy Court will decide whether or not to approve the new credit facility or loan.

If a company in Chapter 11 bankruptcy has existing secured loans, and it wants to borrow on a secured basis that is equal or senior to the existing loans, one, it will need to obtain the existing lender’s consent to the new facility, or two, it will have to convince the Bankruptcy Court that the existing lender will be “adequately protected” (their position will not be degraded by the new DIP credit facility).

A current lender who provided financing to the firm prior to its bankruptcy filing may be willing to commit to a DIP business bankruptcy loan, even if it has declined to make further advances prior to the bankruptcy proceeding. In addition to the added protections under the Bankruptcy Code, the lender may also have its own goals in making the DIP loan, for example, to help improve the company so that it can ultimately be sold to another party.

If the Bankruptcy Court approves a DIP loan or funding facility and finds that it was made in good faith, the loan will not be subject to legal challenge. That differs from the same loan made outside of bankruptcy, which might have been subject to challenge.
How is Accounts Receivable Factoring used in DIP financing?

Companies can also use AR factoring as a financing tool in DIP financing, a possibility that many small business owners do not realize. In fact, accounts receivable financing can be the most fast and flexible ways to obtain financing and recapitalization during the Chapter 11 bankruptcy process. Factoring can be a win-win for both the borrowing company and the factoring firm. The company obtains needed financing that is not based on its own credit status, and the factoring firm achieves priority status under the Bankruptcy Code. Many times it was customer credit issues that pushed a company into bankruptcy. A Paragon Credit Protected AR Facility stops that from happening again.

The Bottom Line in a Tough Business Situation

If your company is experiencing financial distress, it's important to consult an experienced bankruptcy attorney and a restructuring/turnaround specialist to determine all of your viable options. A workout or other restructuring process outside of bankruptcy might be a better option for your unique situation. However, if you determine that bankruptcy is your best option, DIP financing may provide a strong opportunity to help turn your company around. With Paragon as your DIP Funding Provider, we can offer our two decades of expertise in Debtor In Possession Facilities, bankruptcy exit financing, and other creative workout/distressed working capital solutions.