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Guest Article

Recent Trends and Developments in DIP Financing

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A debtor facing a possible Chapter 11 filing usually will need some form of debtor-in-possession ("DIP") financing in order to fund operating and restructuring expenses during its bankruptcy case. Few things are more important in the tumultuous events leading up to a Chapter 11 filing than the debtor securing adequate DIP financing. Most debtors are strapped for cash by the time management decides a bankruptcy filing is necessary, and the terms of the financing ultimately obtained often go a long way in determining the ultimate outcome of the bankruptcy case. The debtor's employees, trade vendors, and even the professionals in the case will pay very close attention to the debtor's post-petition Cash Flows, and the existence of a DIP loan can provide the various constituencies with the assurance that there will be sufficient funds to pay their post-petition claims. Without DIP financing in place, employees may seek other employment and critical vendors may choose to discontinue business with the debtor for fear of not getting paid. A well-structured DIP facility can calm these fears and allow the debtor's business to stabilize while the debtor pursues its reorganization strategy.

Overview

Post-petition borrowings are governed by section 364 of the Bankruptcy Code. If a debtor is unable to obtain unsecured post-petition credit (and it rarely can) under section 364(a) or 364(b), it may obtain post-petition financing under section 364(c) or section 364(d). Under section 364(c), after notice and a hearing, DIP financing may be approved that provides the lender with a superpriority administrative claim and with a lien on unencumbered property, or a junior lien on encumbered property. Under section 364(d), the Bankruptcy Court may approve DIP financing with a priming lien provided the debtor shows that non-priming credit is not otherwise available, and provides adequate protection to the holder of any liens that are primed. The debtor bears the burden of proof on adequate protection.

Types of DIP Financings

Defensive DIP Financings. A defensive DIP financing usually is provided by one or more of the debtor's existing pre-petition lenders or bondholders. Such creditors are motivated to provide a DIP loan to their borrower for a number of reasons. They understand that the DIP loan may be necessary to preserve the value of their collateral. Without the DIP loan the debtor may be forced to shut down its operations and the debtor's assets may be worth more as a going concern than in a liquidation. Also, they understand that, depending on the value of the collateral and whether the debtor can provide adequate protection, they may want to avoid a priming fight with another third party lender that would seek to obtain a priming lien on the pre-petition lender's collateral. Rather than engaging in an expensive priming fight with the debtor, with significant downside should it lose, a pre-petition lender often chooses to fund the debtor's post-petition operations with a DIP loan. Additionally, the DIP lender may be able to condition the loan on the debtor being required to meet certain restructuring milestones thus providing the lender with control over the direction of the debtor's restructuring.

Offensive DIP Financings. Offensive DIP financings typically are provided by a lender that is not a pre-petition lender, or by a lender that recently acquired pre-petition debt with an eye to becoming a DIP lender. Offensive DIP lenders often are pursuing a "loan to own" strategy. They know that the DIP loan will receive administrative priority in the bankruptcy case, and making a DIP loan may be the cheapest way for the lender ultimately to obtain control of the debtor's assets and the direction of the debtor's restructuring. Offensive DIP financings that are not consented to by the existing secured pre-petition lenders are rare because debtors will have a hard time providing adequate protection and often times lead to expensive litigation early in the bankruptcy case regarding the value of the debtor.

DIP Lenders

Prior to the 2008 financial crisis, large banks (along with GE Capital) were the most common DIP lenders. After the financial crisis, many of the large banks reduced substantially the number of DIP loans they made to distressed companies. After the financial crisis, private equity firms and hedge funds became significant players in the DIP financing market. This is in part because of the funds' active involvement in the acquisition of bonds and equity in distressed companies. As the markets have improved, the large banks have returned to the DIP financing arena and this trend continues. Some of the largest recent DIP loans have been made by large banks and financial institutions.[1]

DIP Loan Terms

Interest Rates and Maturity. After the financial crisis, interest rates on DIP loans rose significantly.[2] Because many banks exited the field, many private equity firms and hedge funds became DIP lenders because they were attracted by the higher yield DIP loans and by the priority treatment that the DIP loans receive in a bankruptcy case. The interest rates from recent cases do not necessarily suggest an overall trend of lower rates. The rates appear to reflect more on the quality of the credit than an overall trend of lower rates.[3]

After the financial crisis, the maturity dates of the typical DIP loan were dramatically reduced. Maturity dates often extended up to two years prior to the financial crisis, but now DIP loans often mature in a year or less.[4] This trend seems to be continuing. Several reasons could explain the reduced maturity period. Recent changes to the Bankruptcy Code (that some find troubling[5]) and a recent Supreme Court case continue a trend that favors secured lenders' rights in bankruptcy cases.[6] Such lenders may believe they can defeat a "cram-down" attempt and use their bargaining position to provide a DIP loan on extremely favorable terms. Such terms can include a shortened maturity date and, as discussed below, milestones and other terms. A cash poor debtor without a viable DIP alternative may have little to no bargaining power to resist the lender's demands. The 2005 amendments to the Bankruptcy Code that limited the debtor's exclusivity period to 18 months may also be a reason for the shortened maturity periods.

Milestones. While not strictly a trend, the vast majority of DIP loan agreements today provide for the debtor-in-possession to meet certain bargained-for milestones in the case after the Chapter 11 is filed.[7] Whether the case will be an orderly liquidation of substantially all of the debtor's assets, or involve a more traditional plan process, the timelines for the case often are set forth in specific detail in the DIP financing agreement. Missing a milestone on the timeline results in a default under the DIP loan agreement, thus giving the lender control over the direction of the restructuring. If the agreement calls for an orderly liquidation there will be a deadline for the debtor to file a motion seeking approval of the bidding procedures for a sale under section 363 of the Bankruptcy Code. The motion must be heard by a certain date, and an auction date and a deadline for final court approval of the sale will be stated. If the agreement calls for a plan of reorganization to be pursued, deadlines will be set for filing the plan and disclosure statement, for approval of the disclosure statement, and for the entry of the order confirming the plan. If the DIP financing agreement does not contemplate an outright sale or a plan process, such a process usually will be triggered if the debtor fails to meet other specific covenants contained in the agreement. All of the court papers, including the loan documents, filed by the debtor will be subject to review by the DIP lender prior to filing.

Intercreditor Agreements. Many cases of substantial size involve multiple layers of secured debt among creditors with different priority. In such cases an intercreditor agreement will govern the respective rights among the secured creditors. The terms of the intercreditor agreement may significantly influence discussions

1 *See In re Energy Future Holdings Corp.*, in the United States Bankruptcy Court for the District of Delaware, Case No. 14-10979-CSS, Dkt 74 (EFHC); *In re Momentive Performance Materials, Inc.*, in the United States Bankruptcy Court for the Southern District of New York, Case No. 14-22503, Dkt 13 (Momentive); *In re James River Coal Company*, in the United States Bankruptcy Court for the Eastern District of Virginia, Case No. 14-31848-KRH, Dkt 24 (James River); *In re Coldwater Creek, Inc.*, in the United States Bankruptcy Court for the District of Delaware, Case No. 14-01867, Dkt. 12 (Coldwater Creek).

2 Nakhil Abraham and Abitya Habbu, DIP Lending and the Death of Emergence: Reorganization Outcomes Post-Crisis, Table 3 and Figure 2, printed at http://www.turnaround.org/Education/ResearchPapers.aspx.

3 *See, e.g.*, EFHC, Dkt 73 (the $4.475 billion DIP loan to Texas Comparative Elect. Holdings Co. is more akin to a conventional, broadly-syndicated facility than a DIP facility).

4 *See, e.g.,* Momentive (one year); Coldwater Creek (four months); James River (nine months).

5 Testimony of Harvey R. Miller before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee, 111th Congress, 1st Session for Hearings on 'Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?' March 11, 2009, at 14, accessed on June 23, 2014 at http://judiciary.house.gov/_files/hearings/printers/111th/111-6_47924.PDF.

6 *See RadLAX Gateway Hotel, LLC, et al. v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) (plan providing for sale of property free and clear of secured lender's claims may not be "crammed down" over secured creditor's objection when the plan barred the secured creditor's right to credit bid).

7 These are in addition to the basic milestones for filing the bankruptcy case such as obtaining approval of the DIP financing on an interim basis, and obtaining final approval of the DIP financing.

among the debtor and the first and second lien creditors over the terms of a DIP loan from either or both of the secured lien holders. The typical intercreditor agreement will be based on the Model First Lien/Second Lien Intercreditor Agreement promulgated by the American Bar Association's Model First Lien/Second Lien Intercreditor Agreement Task Force. Of course, the specific terms of any intercreditor agreement are subject to negotiation and the terms will vary. The intercreditor agreement may limit the second lien holder's right to object to a DIP financing consented to by the senior lender, and it may limit the junior lienholder's right to object to the adequate protection received by the senior lender.

Roll-ups. As a condition to making a post-petition DIP loan, a pre-petition secured lender may require the debtor to convert all or a portion of the existing pre-petition secured debt into the post-petition DIP loan. As such, the pre-petition secured debt is "rolled up" into the DIP loan. The result is that the entire debt (including the usually large pre-petition secured debt) becomes a priority post-petition administrative claim that must be paid in full upon the confirmation of the Chapter 11 plan, unless the DIP lender otherwise consents. A roll-up DIP should only occur when the debtor has no other viable options for a DIP loan except through the rolled-up DIP loan. Roll-up DIP loans became common after the 2008 financial crisis. One would expect that, as the credit markets continue to improve, roll-up DIP financings would become less popular.[8] The burden that a rolled-up DIP can place on a debtor can be significant. The consequences of burdening the estate with such a huge administrative claim and other burdensome requirements (milestones, financial conditions, etc.) often seals the debtor's fate from the outset.[9] Because of this, many bankruptcy judges are reluctant to approve rolled-up DIP loans.

Conclusion

While the continued improvements in the financial markets should result in more competition, lower rates, and better terms for debtors, it is hard to say that a trend in that direction has been established. Every situation is unique and the availability of a DIP loan and its terms to a particular debtor will depend on several factors, including the parties' bargaining strength, the value of the debtor's assets, and competition, or lack thereof, for making the DIP loan. The sooner the debtor explores its DIP financing options — oftentimes with the assistance of an investment banker or financial advisor — the better its chances will be to obtain a favorable result.

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8 However, several recent large DIP financings are, at least in part, rolled up financings. *See e.g.* EFHC, Momentive, and Coldwater Creek, cited above at n. 1.

9 *See, e.g., In re ATP Oil & Gas Corp.*, in the United States District Court for the Southern District of Texas, Case No. 12-36187, Dkts 21, 1168 (a $617 million DIP rolled up $367.5 million of prepetition debt and it also contained numerous performance based conditions; within 19 days of entry of the final DIP order a "Specified Event" occurred eventually leading to the sale of substantially all of the debtor's assets to the DIP lender via credit bid; the case recently was converted to a case under Chapter 7).