

Trends in DIP Financing: Not as Bad as It Seems?

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The financial world in general and the credit markets in particular have changed significantly in the past 12 months. This article does not attempt to recap the causes or developments that led to this new, different financial and credit environment. Those developments are by no means complete.

The limited purpose of this article is to examine recent trends in debtor-in-possession (DIP) financing and how they are affecting a debtor's ability to file, the timing of the filing, and the length and outcome of a case once it is filed. It also briefly addresses the prospects for DIP financing in the future.

The structure for DIP financing contained in Section 364 of the Bankruptcy Code was among the most fundamental and innovative provisions of the statute passed in 1978. Prior to the advent of the Bankruptcy Code, trustees or receivers issued what were called "receiver's certificates" to obtain financing for bankrupt companies (originally, for railroads). But the proceeds of the receiver's certificates were good only for specific expenditures.¹

Section 364 set forth a specific hierarchy of priorities governing all post-petition financing. DIP financing agreements eventually took on an important role as a governance mechanism, allowing DIP lenders to exert significant oversight and control over a debtor's risk-taking activities.²

Despite the increasing importance of DIP financing agreements, bankruptcy judges and the U.S. Trustee were not always given the time and opportunity to subject these agreements to the scrutiny they deserved. It was not unusual for a debtor and secured lender to submit a lengthy and prolix motion for approval of a DIP financing agreement (along with a cash-collateral agreement) shortly after the filing and to insist that they had to be approved on an emergency basis to allow the debtor to continue operating.³

Partly to bring clarity and transparency to the DIP financing approval process, Federal Rule of Bankruptcy Procedure 4001(c) was amended in December 2007. The amended rule now requires that a motion requesting approval of a DIP financing agreement contain a concise statement of, among other things, the location within the agreement of all material provisions of the proposed agreement, including interest rate, maturity, events of default, liens, borrowing limits, and conditions. The statement also must address the grant of priority, provision of adequate protection, and any waiver or modification of Bankruptcy Code provisions relating to the automatic stay.⁴

These amendments were intended to focus attention on what has become an extremely important part of the reorganization process.

Troubles of Their Own

DIP loans traditionally were viewed as safe and profitable for lenders and were almost taken for granted by many potential debtors. A 2006 article about DIP lending concluded that “[i]ndeed, because of the many lender protections enshrined in the U.S. Bankruptcy Code to induce [DIP] lending, the safest loans in a troubled industry may well be those made to bankruptcy debtors.”⁵ As recently as 2004, a prominent bankruptcy scholar could write that “generous terms offered to [DIP] financiers have encouraged lenders to make loans to cash-starved debtors, and...these lenders have used their leverage to fill a governance vacuum that was created by the enactment of the 1978 Code.”⁶

Things have changed. Today many are concerned that the market for DIP financing has all but disappeared. What caused this? Few would argue that it was closely related to the credit crisis, which emerged during the spring and summer of 2008. The first indication many bankruptcy practitioners had that the DIP market was shrinking was an October 2008 article in *The Wall Street Journal* that cited General Electric’s “recent, undisclosed decision to largely halt lending to companies in bankruptcy...”⁷

The article also quoted prominent bankruptcy lawyers who said that it had become a struggle to find DIP financing and that the number of willing lenders had shrunk from more than 30 to five or six in only a two-year period. The article caused considerable concern in the bankruptcy bar because GE was the leading DIP lender in dollar volume in the country. If a lender of its size and experience was exiting the market, practitioners were concerned that there would be far fewer options for debtors in need of such financing.

Although it was not mentioned in the newspaper article, the most immediate cause for this shrinkage in the availability of DIP financing was not a mystery. Lehman Brothers had been a significant DIP lender until its precipitous decline into bankruptcy on September 15, 2008. Both Merrill Lynch and Wachovia Bank also had sizeable units that made DIP lending a specialty before each was sold to other banks to avoid having to file for bankruptcy protection themselves. Other DIP lenders no doubt pulled in their horns upon seeing so many major players exit the field.

In addition to the shrinking number of lenders, other factors conspired to make traditional DIP financing more difficult to obtain. One was the amount of prepetition secured

financing that potential debtors had taken on in the past few years, when financing of all types was much easier to obtain. The increasing popularity of mezzanine funding,⁸ leveraged lending, second lien debt, and securitization only exacerbated this trend. Potential debtors were contemplating bankruptcy with extremely leveraged balance sheets. As a result, they would have little, if any, unencumbered collateral to offer a prospective DIP lender upon entering a Chapter 11 proceeding.

The scarcity of DIP financing has had several effects — some predictable, some not.

First, unsurprisingly, has been an increase in price. Some sources have noted that DIP facilities that previously had been available at LIBOR plus 250 basis points were priced at LIBOR plus 600 basis points.⁹ A more recent report suggested that debtors should expect to pay up to 1,200 basis points over LIBOR.¹⁰ Debtor Lyondell Chemical is reportedly paying an interest rate of 20 percent for its DIP facility.¹¹ Fees have also increased.

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Second, lenders are making more use of covenants in their DIP loans. The days of the so-called “covenant-lite” loans are very likely over. Also, the terms of DIP loans are shorter than those granted before the credit crunch. While DIP terms of 12 to 18 months were not unusual in the past, more recently two to six months have been the norm.

Clearly, these shorter terms have follow-on effects of their own, primarily leaving debtors with less time to negotiate a proper restructure. As would be expected, this leads to more Section 363 sales.¹² In fact, prospective 363 purchasers themselves may even provide DIP financing for the express purpose of providing a “bridge” to the 363 sale. Even if it is not the prospective buyer providing the DIP financing, a traditional DIP lender often is only willing to extend financing until a Section 363 sale.

There also has been speculation that with the shortage of DIP lenders — existing lenders of prospective debtors, the so-called “defensive DIP lenders” — will have an advantage in negotiating terms with their borrowers, putting further upward pressure on rates and fees.

Encouraging Signs

While these facts are difficult to refute, there are signs that the bankruptcy system will find ways around the current crisis.

First, not every Chapter 11 debtor needs to obtain DIP financing. A 2003 study showed that at least half of all publicly traded companies entering Chapter 11 did not need or obtain DIP financing.¹³ A recent example is Trump Entertainment Resorts and its nine subsidiaries, which filed Chapter 11 petitions in February in the Bankruptcy Court for the District of New Jersey. Trump Entertainment did not seek DIP financing “because it currently has adequate cash resources to fund its ongoing business operations.”¹⁴

Such considerations have led some prospective debtors to consider bankruptcy much earlier in the process than they otherwise would, with the intent of entering Chapter 11 with sufficient cash reserves to emerge successfully from the case without having to obtain DIP financing. A December 12, 2008, Reuters article reported that Nortel was considering bankruptcy if its own restructuring plan failed, despite its significant cash levels. A banker quoted in the story referred to it as a “preemptive bankruptcy,” presumably because its cash levels were much higher than that of a typical debtor entering bankruptcy.¹⁵ However, it is questionable whether enough potential debtors have both the foresight and cash reserves necessary to make “preemptive

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bankruptcy" a viable counterweight to a perceived reduction in DIP lenders.

More promisingly, early reports of the demise of GE's DIP lending business were greatly exaggerated. In January, Gottschalks, a regional department store chain in the western U.S., negotiated a \$125 million DIP facility with a group led by GE, and Rob McMahon, managing director for restructuring at GE Commercial Finance, has stated that he is "very optimistic" about DIP loans for 2009. Representatives of Deutsche Bank and Barclays plc have made similar comments about the DIP market.

As further evidence that the market is not totally moribund, one of the largest DIP facilities ever assembled was approved in 2009. Southern District of New York Debtor Lyondell Chemical recently obtained a DIP facility totaling \$8 billion, which consisted of existing senior secured credit facilities, as well as new funding.

Moreover, Aladdin Capital Holdings, a Stamford, Connecticut-based asset manager and hedge fund, recently started a fund, the

first of its kind, which will "participate, structure and lend directly into both large cap and mid cap" DIP facilities.¹⁶ Although hedge funds' investment strategies should not be used as reliable predictors of future trends, this development may be an indicator of the investment community's perception of an unmet need.

Supply vs. Demand

DIP financing was a topic of discussion at the Distressed Investing Conference, co-sponsored by TMA and *The Deal* and held in January. *The Deal's* market trend data showed that DIP financing during 2008 was at its highest level in five years, at \$18.1 billion, representing a 33 percent increase over 2007.

The number of DIP deals also rose, to 328, a 41 percent increase. Of course, these statistics should be viewed in the context of bankruptcy filings as a whole for the year. As *The Deal* pointed out, during 2008 there were 160 bankruptcy cases filed involving assets of more than \$100 million. During the previous year, only 50 such cases were filed.

During 2008, GE was the dominant DIP lender in volume, with \$1.96 billion in 21 deals. Wells Fargo and Barclay's plc followed with \$1.5 billion and \$1.3 billion, respectively. Wells Fargo was first in terms of number of deals at 38, followed by Bank of America at 24 deals, and GE at 21.

In summary, the DIP market expanded significantly during 2008, although not enough to keep up with the much larger increase in the number of bankruptcies. In other words, the DIP market has not withered or closed down, as many have supposed, but merely has not been able to keep up with the increase in Chapter 11 petitions.¹⁷ ☐

¹ See David A. Skeel, Jr., "The Past, Present and Future of Debtor-in-Possession Financing," 25 *Cardozo L. Rev.* 1905 (April 2004).

² See *id.* at 1923.

³ John D. Ayer, Michael L. Bernstein & Jonathan Friedland, "Obtaining DIP Financing and Using Cash Collateral," 23-7 *ABIJ*, September 2004.

⁴ This is an abbreviated recitation of the extensive amendments to Rule 4001(c). Consult the rule in its entirety for a complete list of the requirements for disclosure in a motion for approval of a DIP financing agreement.

⁵ Marshall S. Huebner, "Debtor-In-Possession Financing," *The RMA Journal*, April 2005.

⁶ David A. Skeel, Jr., *supra* at 1906.

⁷ Jeffrey McCracken & Paul Glader, "DIP Loans are Scarce, Complicating Bankruptcies," *The Wall Street Journal*, October 17, 2008.

⁸ One source has referred to mezzanine funding as "an outgrowth of hedge funds with not enough places to put their money..." See Christine Caulfield, "Dried-Up DIP Financing to Intensify Chapter 11 Sell-Offs," *Law 360*, October 20, 2008.

⁹ See, e.g., Kelly Holman, "DIP Finance Providers Disappear," *IDD Magazine.com*, October 27, 2008; www.iddmagazine.com/issues/2008.

¹⁰ See "Double DIP: Bankruptcy Loans Scarce and Scary Expensive," *Financial Week*, January 19, 2009, Reuters; www.financialweek.com/apps/pbcs.dll.

¹¹ See Michael de la Merced, "Bankruptcy Could Be More Costly," *The New York Times*, Feb. 18, 2009.

¹² More than five years ago Weil, Gotshal's Harvey Miller (then at Greenhill and Company) lamented that the direction of Chapter 11 was toward ever more asset sales and auctions, with the days of traditional negotiated reorganizations in the past. Many would assert his prediction was correct. See Terry Brennan, "Miller: Liquidations Set to Rise," *The Deal*, Dec. 2, 2003.

¹³ Sandeep Dahiya *et al.*, "Debtor in Possession Financing and Bankruptcy Resolution: Empirical Evidence," 69 *J. Finan. Econ.* 259, 266 (2003). However, data for that study was compiled in 1997, and the percentage of Chapter 11 debtors obtaining debtor-in-possession financing may have risen since then.

¹⁴ "Gaming: Trump Entertainment Resorts, Subsidiaries File Under Chapter 11 Seeking to 'Deleverage,'" *Bankruptcy Law Daily*, Feb. 18, 2009.

¹⁵ Nortel did eventually seek bankruptcy protection on January 14, 2009, both in Delaware and, under the Companies' Creditors Arrangement Act (CCAA), in Toronto, Canada. Export Development Canada, a government-owned bank and insurer, agreed to provide Nortel with up to \$30 million in loans for the first 30 days of the bankruptcy.

¹⁶ See Alex Chambers, "Restructuring: Aladdin Opens DIP Fund," *Euromoney.com*, March 2009; www.euromoney.com/Article/2119087/Current-Issue/70610/Restructuring-Aladdin.

¹⁷ Although it's much too early to predict how 2009 will turn out, these major DIP deals were announced during February and March alone:

- Lyondell Chemical (S.D.N.Y.): \$8 billion
- Aleris Int'l, Inc., (Delaware): \$1.1 billion
- Chemtura Corp. (S.D.N.Y.): \$400 million
- Spectrum Brands (W.D. Texas): \$235 million
- Foamex (Delaware): \$95 million
- Frontier Airlines (S.D.N.Y.): \$40 million
- Merisant Worldwide, Inc. (Delaware): \$20 million.

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