Key Developments and Trends in DIP Financing

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A summary of recent developments in DIP financing.

Interest in the DIP financing market on the part of both traditional bank lenders and a new class of institutional investors has continued to increase in recent years, as market participants continue to pursue the generally attractive returns relative to risk that properly structured DIP financings can provide.

In 2014, the Energy Future Holdings Corp. bankruptcy cases were funded with a combined $9.9 billion of DIP financing under two facilities: a $5.4 billion DIP for the company's electricity generating subsidiary and a separate $4.5 billion DIP for its electricity transmission unit. Excluding this massive outlier, however, the volume of new DIP financings during 2014 was generally down compared to 2013, due to a decline in the filing of large bankruptcy cases. Nevertheless, overall bargaining power still weighs generally in favor of DIP lenders. This has allowed DIP lenders to continue to demand higher interest rates, shorter maturities, tighter covenants and more restrictions (such as shorter deadlines to sell assets or to sell the entire company), resulting in more DIP lender control over the debtor and the Chapter 11 process.

While there are unique company and industry challenges that impact this identification of other specific trends, recent developments in DIP financing have been focused in these areas:

- **Interest rates.** Interest rates on DIP loans historically were about 200 to 400 basis points above LIBOR. However, in 2008 and 2009, pricing increased to the range of 600 to 1000 basis points or more above LIBOR. At the peak of the credit crunch, some DIP loans were priced at 1200 basis points above LIBOR. Together with increasing fees (see below), DIP lenders received percentage point returns in the mid to upper teens (or higher) in 2008 and 2009. Rates are now well off their 2009 peak, averaging LIBOR plus 675 basis points for term facilities, with revolving credit facilities (which are often asset-based facilities) generally averaging LIBOR plus 350 basis points. Experts predict that interest rates should continue to stabilize.
- **Fees.** DIP fees have included significant upfront and, less frequently, exit fees, each often in the range of 2% to 4% of the loan amount. Upfront fees more recently have generally been closer to 2%. Initial arrangers have also demanded fees for arranging, underwriting and syndicating the loan. However, increasing competition from DIP lenders, coupled with a relative scarcity of new DIP financings, has resulted in a drop in these fees.
- **Underwriting and syndication.** DIP loan arrangers almost always provide fully underwritten commitments, as potential debtors are reluctant to risk a bankruptcy filing without having committed bankruptcy financing. Arrangers typically reserve the right to syndicate their commitments, but out of concern for confidentiality often agree not to do so before the bankruptcy filing has been made. To reduce underwriting risk, deals are sometimes committed to by multiple arrangers, as in the leveraged loan market generally. Market flex provisions serve to additionally reduce risk.
- **Structure.** While DIP loans were historically structured as unfunded revolvers, structures are increasingly including a funded term loan piece alongside a revolver, largely to:
  - take advantage of strength in the institutional term loan market; and
  - accommodate institutional investors that cannot hold unfunded commitments.

  This has increased the cost of the DIP loan because the debtor must pay interest on the entire amount of the funded loan rather than just a lower commitment fee on committed capital under the revolver. In addition to traditional ABL/term "crossing lien" structures, the recent Exide Technologies DIP used a "first-out, second-out" structure, with the ABL revolver having the first-out position on all collateral.
- **Covenants.** DIP loan covenants have tightened and are more onerous on the borrower. Affirmative covenants known as bankruptcy milestones continue to be popular. They require the debtor to satisfy certain objectives within a specified period of time, for example, setting deadlines for:
  - filing a plan of reorganization;

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  - court approval of a disclosure statement;
  - a confirmation hearing; and
  - entry of a confirmation order.

  Asset sale milestones, which require the debtor to sell assets within a specified period of time in a section 363 sale, have also gained popularity. Bankruptcy milestones often impose unrealistically short deadlines that may hinder debtors from successfully reorganizing, because failure to meet these deadlines often gives the DIP lender the option to sell all of the debtor's assets. This has led to several recent cases that have seen challenges by unsecured creditors to the inclusion in DIP financings of excessively onerous milestones. In addition, the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 recently released its Final Report and Recommendations which, among other things, recommends amending the Bankruptcy Code to provide that milestones for significant actions cannot take effect within the first 60 days following the petition date. Although the report has no legal effect and its recommendations are not likely to be implemented in the Bankruptcy Code for some time (if ever), this proposal is indicative of the increasing opposition to particularly restrictive milestones.

- **Amendment or waiver fees.** As it becomes more difficult to comply with increasingly restrictive covenants (see *above*), debtors have had to seek waivers or amendments to the DIP credit agreement, resulting in increased amendment and waiver fees for DIP lenders. The increasing use of funded term loans sold to institutional investors has exacerbated this trend, as these investors tend to demand more compensation for amendments than relationship banks.
- **Maturities.** Loan maturities, traditionally as long as two years, have been in decline. However, they have been slightly increasing from 2009 lows of about nine months, to a current average of about 14 months. In some cases they have been as short as three to six months, particularly in those cases that contemplate a quick section 363 sale of assets. These short loan durations have not provided debtors with enough time to reorganize, causing many to liquidate rather than to successfully emerge from bankruptcy.
- **MAC and MAE clauses.** Market MAC, company MAC and material adverse effect (MAE) clauses are increasingly being included in DIP commitment letters (as well as in exit financing commitments) (see *Practice Note, Material Adverse Change Provisions: Mergers and Acquisitions (http://us.practicallaw.com/9-386-4019)* and *Standard Clause, Commitment Letter: Company Material Adverse Change Clause (http://us.practicallaw.com/5-381-7751)*).
- **Size.** The largest DIP facilities occurred in 2009 due to economic conditions forcing larger companies to seek bankruptcy protection. For example, in January 2009, Lyondell Chemical Company (Lyondell) received an $8.5 billion DIP, the second-largest single facility on record after the $10 billion DIP received by Calpine Corporation in January 2007. In May 2009, Chrysler LLC received approval of a $4.9 billion DIP. These large DIP packages extended to relatively few borrowers accounted for much of the DIP lending activity during the financial crisis. Smaller loans of under $1 billion have generally accounted for the remainder of the DIP loan market, although the last few years have each contained a notable exception: the $1.6 billion DIP financing for Residential Capital in 2012, the American Airlines DIP-to-exit financing in 2013 and the combined $9.9 billion of DIP financing for Energy Future Holdings in 2014.
- **Lenders.** Commercial banks historically provided DIP loans, but they have somewhat retreated due to their hesitation to lend against precipitously declining asset values. Major lenders (for example, GE Capital) have re-entered the market. Non-traditional DIP lenders with spare capital, such as hedge funds, private equity firms, institutional lenders and collateralized loan obligation (CLO) funds, enticed by the prospect of high yields or the wish to acquire distressed companies, have expanded their role in this market. However, due to a dearth of unencumbered assets to serve as collateral for the DIP loan and expected challenges from existing lenders to the priming of their liens, the market is still dominated by existing lenders (see *below*).

  In the rare case where a third-party lender provides DIP financing, it is typically offered as a bridge to acquire the debtor's assets in a section 363 sale, by using credit bidding or other loan-to-own strategies (see *Practice Note, DIP Financing: Overview: Loan-to-Own Strategy (http://us.practicallaw.com/1-383-4700)*). Therefore, the existing lender, which has the incentive to protect its investment is often the only lender willing to provide DIP financing (see *Practice Note, DIP Financing: Overview: Special Advantages for Existing Lenders Providing DIP Financing (http://us.practicallaw.com/1-383-4700#a388627)*). Debtors themselves have a strong incentive to avoid a first-day priming fight. In some cases, as in the automotive industry, customers that are dependent on the debtor's products have provided DIP financing. In the recent School Specialty case, the US Bankruptcy Court for the District of Delaware approved a $155 million DIP provided by unsecured bondholders, taking out the debtor's private equity secured lender and derailing its loan-to-own strategy.

- **Defensive DIPs and roll-ups.** The existing secured lender is often the DIP lender, due in part to a tight credit market and courts' increased willingness to approve a roll-up of prepetition debt (see *Practice Note, Roll-up DIP Financing (http://us.practicallaw.com/1-386-8691)*). A roll-up improves the priority position of the prepetition debt (see P*ractice Note, DIP Financing Overview: Improved Priority Position of Prepetition Debt (http://us.practicallaw.com/1-383-4700#a388627)*). Often only a portion of the DIP loan is new money (with the balance being comprised of a roll-up or of funds used to repay the prepetition debt), keeping the debtor operating just long enough to liquidate the lenders' collateral. Most roll-ups have been structured as dollar-for-dollar roll-ups to incentivize lenders to fund large amounts of new capital. Notably, the ABI Commission's recently-released Final Report and Recommendations proposes that a court should not approve postpetition financings that contain a roll-up of prepetition debt or will be used to pay down prepetition debt unless the financing is in the best interest of the estate and either:
  - is provided by new lenders; or
  - offers substantial new money and better terms than alternative facilities offered to the debtor.

  These recommendations may signal increasing resistance to roll-ups of prepetition debt.

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Some roll-up tranches have also been structured to convert to post-emergence debt obligations of the reorganized company, subject to the satisfaction of various conditions, rather than being repaid in full in cash at the end of the bankruptcy case. Lyondell's $8 billion DIP loan and Kodak's $830 million junior DIP loan are examples of this modified type of roll-up (see *Practice Note, Roll-up DIP Financing, Box: Lyondell's $8 Billion Roll-up DIP Loan (http://us.practicallaw.com/1-386-8691#a595928)*). Roll-ups continue to be one of the most controversial aspects of DIP financing. Bankruptcy court approval of a roll-up, particularly at a "first day" hearing, is never a sure thing.

- **Club deals.** Arranged and club deals have become more common, with deals being introduced to the market on a market flex basis to allow for adjustments in loan terms if the loans cannot be syndicated.
- **Demand.** Demand for DIP financing volume peaked in 2009 (2009 included the unusually large GM, Lyondell and Chrysler DIP facilities), but has since decreased due to the recent decline in bankruptcy filings. In 2009, DIP lending exceeded $62 billion ($22.5 billion when removing government-funded cases), compared to $18 billion in 2008 and $13 billion in 2007. DIP financing volume decreased to about $15.5 billion in 2010. This downward trend in activity has continued, largely driven by a decline in overall bankruptcy filings. Excluding the Energy Futures Holdings facilities, DIP financing volume in 2014 appears to have been about $1.4 billion.
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- **Equity conversions; DIP-to-exits.** Some DIP financings have included the option to convert outstanding amounts on the DIP loan to equity, giving lenders a potential equity upside and allowing debtors to reduce the amount of cash they must raise in unfavorable markets to repay the DIP loan on emergence from bankruptcy. This is desirable for lenders wishing to execute a loan-to-own strategy (see *Practice Note, DIP Financing: Overview: Loan-to-Own Strategy (http://us.practicallaw.com/1-383-4700#a405944)*). For example, an equity conversion feature was included in the General Growth Properties and ION Media Networks DIP loans. However, these arrangements are not favored by courts because they are at the expense of unsecured creditors, who may have otherwise received this value. As the credit markets improve, equity conversions are likely to decline. Other DIP financings have included the option to convert outstanding amounts on the DIP loan to exit financing. Like equity conversions, these financings enhance the debtor's ability to reorganize by reducing the amount that must be raised at emergence. For example, the Houghton Mifflin Harcourt DIP financing and the American Airlines DIP financing included a DIP-to-exit feature.
- **Junior DIP financing.** A new trend has been the increased use of junior tranches in DIP financings (for example, seen in the Loehmann's Holdings, Borders Group and MPM Silicones DIP facilities). The junior tranche is provided on a "first-in, last-out" basis and allows the debtor to receive immediate access to the entire junior line of credit. The debtor does not repay the junior loans until the senior tranche is paid in full.
- **Outcomes.** Market conditions have resulted in an increase in prepackaged and pre-arranged bankruptcies, which reduce the amount of time spent in Chapter 11 (see *Practice Notes, The Prepackaged Bankruptcy Strategy (http://us.practicallaw.com/9-503-4934)* and *Bankruptcy: Overview of the Chapter 11 Process: Pre-arranged (or Pre-negotiated) (http://us.practicallaw.com/4-380-9186#a480688)* and *Legal Update, Prepackaged Bankruptcies On The Rise (http://us.practicallaw.com/3-500-8546)*). In other cases, the scarcity of DIP financing has caused some companies, such as AMR Corp. (the parent company of American Airlines), the Tribune Company and Nortel Networks Corp., to file "preemptive" Chapter 11 petitions before they run low on cash, to avoid the need for DIP financing.

For summaries of recent DIP credit agreements, see *Practical Law's What's Market database*.

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