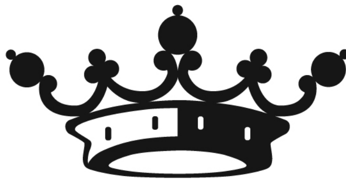
INSIDE THE MINDS

Debtor-in-Possession and Exit Financing

Leading Lawyers on Securing Funding and Analyzing Recent Trends in Bankruptcy Financing



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An Overview of Debtor-in-Possession Financing

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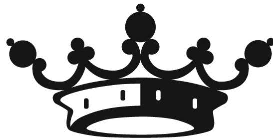

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Introduction: The Importance of Obtaining DIP Financing

Obtaining DIP financing is an integral step in the bankruptcy case of most debtors. DIP financing provides the debtor with liquidity to fund its ongoing working capital needs and serves as an important signal to the marketplace that the debtor will have the ability to fund its ongoing operations during the pendency of its Chapter 11 case. Vendors and customers of the bankrupt company may be skittish about doing business with a company undergoing a Chapter 11 restructuring because of concerns that the debtor company may cease operations. Vendors are concerned about the debtor's reliability with respect to ongoing payments for the goods and services supplied to the debtor while the debtor reorganizes, while customers are concerned about the possibility of unfulfilled orders and worthless warranties. If vendors and customers act on these concerns, vendors will not extend trade credit to the company and customers will take their business elsewhere, thereby exacerbating the company's financial problems. Individual vendors and customers may not have the incentive or information to assess a debtor company's likelihood of reorganizing and emerging from bankruptcy or fulfilling its ongoing obligations, but the attainment of a DIP facility provides the debtor with the funds necessary to reorganize and sends an important signal that financially sophisticated lenders providing the debtor with capital have confidence in the debtor's ability to fulfill its post-petition obligations.

Defensive and Offensive DIPs

There are two major types of DIP financings: defensive DIPs and offensive DIPs. Defensive DIPs are provided by the debtor company's existing pre-petition lenders, usually the senior-most lenders in the capital structure. Offensive DIPs are provided by new lenders that are not already creditors in the debtor's bankruptcy case.

Defensive DIPs

Pre-petition lenders may extend new credit to the bankrupt borrower for a number of reasons, but the primary motivation is protecting the value of their pre-petition credit exposure to the debtor. Their desire is to maximize

their recovery on this pre-petition debt. Often, there is not enough liquidation value in the debtor's business for existing lenders' pre-petition debt to be paid in full. If new credit is not extended to the debtor company in the form of DIP financing, the company may be forced to shut down its operations and liquidate its assets. However, the debtor and its assets are usually worth more as a going concern than in liquidation. The pre-petition lenders therefore will finance the ongoing operations of the company in bankruptcy in an effort to maximize their recovery. Such financing permits the company to sell its assets or operations as a going concern or to effectively reorganize its operations and emerge from bankruptcy with a stronger balance sheet and streamlined operations that will, hopefully, permit it to repay a greater proportion of its pre-petition debt.

Defensive DIP lenders may also be motivated by a desire to have some control over the bankruptcy process. DIP lenders have the ability to exert a degree of control over the debtor company and the Chapter 11 process, principally by imposing covenants on the debtor under the DIP credit agreement. These covenants may require that the debtor provide more detailed information about its operations and financial situation than would otherwise be required by the bankruptcy court (or a non-bankruptcy loan document), giving the DIP lenders an inside view of the debtor's financial condition and the progress of its operational restructuring efforts. The DIP lenders may also require the debtor to comply with other specific requirements, such as compliance with a budget or maintaining a specified level of revenue or cash flow or accomplishment of certain bankruptcy milestones within a specified period of time.

Offensive DIPs

Offensive DIPs are typically provided by new lenders or existing lenders that acquired their pre-petition debt in anticipation of a bankruptcy filing. There are a number of reasons lenders get involved in DIP financing other than to protect their existing exposure to the debtor. A lender may offer DIP financing as part of a "loan-to-own" strategy. The loan-to-own strategy refers to the strategy whereby a lender invests in the DIP loan to influence the bankruptcy process in a manner that will result in the conversion of either the DIP loan or the lender's pre-petition debt into a

controlling equity stake pursuant to the debtor's reorganization. These strategies are most commonly pursued by hedge funds, private equity firms, and distressed trading firms, rather than by commercial banks. Unlike commercial banks, hedge funds and private equity firms generally want to acquire equity in a company and profit from the sale of the company, a public offering of its equity shares, or another exit transaction. Therefore, such financial entities may be willing to offer DIP financing that will convert into equity in the reorganized company upon its emergence from bankruptcy. Since DIP financing generally must be paid in full in cash upon a company's emergence, the equity conversion feature offered in this scenario may be advantageous to the debtor company because the company does not have to raise the cash necessary to pay off the DIP loans to exit bankruptcy.

Lenders may also participate in DIP financings for the pure economics of the loan transaction. DIP loans are generally the senior-most obligations of the debtor company and, unless the lender consents otherwise, must be paid off in full in cash upon the conclusion of the bankruptcy. However, despite this generally low risk profile, DIP loans may provide an opportunity for the DIP lender to collect higher interest and fees than it could from providing a non-bankruptcy loan. In the recent downturn, it became common for DIP loans to be priced at 600 to 1,000 basis points (or more) above LIBOR and to include up-front fees and exit fees (often 3.5 percent of the principal amount of the facility or more each) in addition to high interest rates. Therefore, during this downturn, DIP loans have been providing returns to lenders in the mid to upper teens (or higher) on relatively safe investments.

DIP Market Participants

A number of different types of entities are active in the DIP lending market. Historically, commercial banks provided most DIP financing. But as traditional lenders retrenched during the recent credit crisis, alternative sources of funding, such as hedge funds and private equity funds, have become increasingly prevalent.

The financial entities involved in the DIP financing market often have different investment approaches, objectives, and time horizons. In

deciding whether to provide a company with financing, all lending institutions look at the fundamental economics of the financing, such as the interest and fees offered and the creditworthiness of the borrower. However, commercial banks, which traditionally set the tone for the DIP financing market, may also consider future revenue opportunities that can be gained by establishing and maintaining a relationship with the debtor company. Such future revenue opportunities may include underwriting and advisory business from the debtor following its emergence from bankruptcy. Banks' motivations to offer DIP financing may be influenced by these anticipated returns that are unrelated to the DIP financing itself. Banks therefore may offer attractive pricing on DIP facilities to maintain and strengthen their relationship with the company.

In contrast, hedge funds and private equity firms generally seek to realize the maximum return possible on individual investments in DIP facilities. Throughout the recent credit crunch, hedge funds and private equity funds expanded their role in the DIP financing market as commercial banks reined in their lending, which was perhaps a significant contributing cause to the marked escalation in DIP pricing during this cycle. However, as discussed above, hedge funds and private equity funds may themselves have alternative motives for investing in DIPs, such as embarking on a loan-to-own strategy or, in the case of a private equity fund providing DIP financing to its portfolio company, maintaining control over the bankruptcy process.

Inter-Lender Issues

The mix of lenders in a DIP syndicate can lead to inter-lender issues. Other than the desire to maximize the economic return provided by interest and fees, lenders' concerns when negotiating and investing in DIP facilities are individual to each lender, depending on its motivation for supplying the DIP financing. For example, a commercial bank trying to protect its pre-petition claim has a different motive for participating in a DIP facility than a lender seeking to own a controlling stake of equity in the reorganized debtor. Each of those lenders has a different motive for investing in a DIP facility than a private equity fund sponsor that already owns the debtor company (but may lose ownership due to the bankruptcy process). The varying motivations of each of these players cause them to look at the

financing through a different lens and have different concerns. Because DIP facilities (particularly large ones) are typically arranged by a number of institutions, trying to address all these different lenders' concerns in structuring the DIP facility and producing an agreeable framework for the financing can involve complex "herding cats"-type negotiations.

Private equity sponsor participation in the DIP financing of a bankrupt sponsor portfolio company became more common in the recent economic downturn. Private equity firms bought companies using substantial amounts of debt. Now many of these companies are unable to service that debt. The private equity investment professionals may still believe in the fundamentals of a portfolio company and that the company has good prospects once relieved of its debt burden. Because their current equity is likely worthless, these private equity firms must reenter the capital structure at a more senior position to ensure continued ownership of the enterprise following reorganization. To enable continued ownership of the company following reorganization, private equity sponsors may consent to their DIP loan being converted into equity in the reorganized company upon emergence, which makes it easier for the company to pay off the DIP.

Sponsor participation in the DIP financing of its bankrupt portfolio company can be quite controversial and can lead to odd results, particularly when the sponsor holds positions at different levels of the company's capital structure (i.e., not just the equity). In one recent example, the sponsor became a creditor of a portfolio company pre-bankruptcy and joined in another creditor's opposition to its portfolio company's proposed DIP facility (a seemingly odd decision, but economically rational under the circumstances). Pre-petition creditors (who may not recover in full) are often suspicious of an out-of-the-money equity sponsor's participation in the DIP facility. Pre-petition lenders participating in the DIP to protect their pre-petition exposure may not want the sponsor to influence the reorganization process through the DIP. The pre-petition lenders want to maximize their recovery. The sponsor though, if it will own equity in the reorganized debtor, will prefer to minimize recovery to the pre-petition lenders and maximize the upside value of the equity in the reorganized company. The sponsor's participation in a DIP syndicate is one of the many inter-lender issues that arise when lenders with different motivations participate in the DIP financing.

Recent Trends in the DIP Financing Market

Recent turmoil in the credit markets, coupled with the bankruptcies of many companies, has led to changes and innovations in the DIP financing market. In the DIP financing market, as in the market overall, credit has become more difficult and more expensive to obtain, and those willing to provide credit have sought and received greater protections. As of the writing of this chapter, the credit markets have begun to ease up and perhaps DIP financing terms will eventually return to their pre-credit crunch form, but it is too early to tell when and to what degree that will happen.

Shorter Maturity for DIP Facilities

One of the biggest changes in the DIP market is the shorter tenor of post-credit crunch DIP facilities. Prior to the credit crunch, a two-year maturity for DIP facilities was customary. Two years was considered enough time for the debtor to reorganize itself and emerge from bankruptcy. The recent trend is for maturities of one year or less. These shorter-maturity DIP facilities may not provide the debtor company with enough time to reorganize and emerge from bankruptcy. Rather, it could be argued that these DIP facilities provide the company with working capital to maintain operations, and thus preserve the company's going-concern value while the company auctions off its assets (particularly if the shortened maturity is coupled with a requirement to affect an asset sale, another trend). These auctions often involve a sale of the entire business. The proceeds of the auction become property of the estate and are used to pay off the DIP facility first, then to pay, to the extent possible, pre-petition claims. The senior-most pre-petition lenders will often provide the DIP for the purpose of maintaining going-concern value while the business is marketed and sold, because they will generally recover more on their pre-petition claims if they extend new credit to the debtor to maintain operations than they would if the business were to run out of money, close its doors, and liquidate its assets.

The 2005 amendments to the Bankruptcy Code may also have been a contributing factor to the shortening of the tenor of DIP facilities. The amendments limited the debtor's exclusivity period to file a reorganization plan to eighteen months and disallowed the seemingly endless extensions of debtor exclusivity permitted under the pre-amended Bankruptcy Code.

Higher Cost for DIP Facilities

DIP financing became quite expensive during the credit crunch. DIP loans are generally considered safe investments because of their priority status in the company's capital structure. Prior to the credit crunch, DIP facilities were often priced at 200 to 400 basis points above LIBOR, but pricing in 2008 and 2009 moved to the range of 600 to 1,000 basis points or more above LIBOR. Some DIP loans negotiated at the height of the credit freeze are priced at 1,200 points above LIBOR. In addition, lenders have demanded significant up-front and exit fees as well, each often in the range of 2 to 4 percent of the facility amount. The high fees and interest rates, coupled with the short maturities, have provided DIP loan investors in 2008 and 2009 with returns in the mid to upper teens and occasionally with returns reaching 20 percent. In addition, the initial arranger of the facility will charge a fee for arranging, underwriting, and syndicating the facility.

Funded Term Loans

Historically, the vast majority of DIP facilities were unfunded revolvers provided by commercial banks. During the recent downturn, DIP facilities have mostly been funded loans rather than unfunded revolvers. Due to the credit crunch and commercial banks' concerns regarding their own liquidity and capital requirements (and capital charges associated with unfunded capital commitments), unfunded capital has become more difficult and more expensive to obtain. Debtors, therefore, are receiving funded loans even in instances when they do not have an immediate need for the full amount of the loan. This change in the market increases the cost of the loan, because the borrower must pay interest on funded loans rather than just the lower commitment fee on committed capital.

Increased Complexity of DIP Financing

Arranging DIP financing has become increasingly complex. Putting together a financing syndicate in today's market can be a challenge, both because of the recession and credit crunch, and due to changes in the financing market in general. There is often a more diverse group of investors involved in a company's pre-petition capital structure than historically was the case, and the capital structure itself is often more complicated than it was in the past. Commercial banks, hedge funds,

distressed debt funds, private equity funds, and collateralized loan obligations may each own a piece of one or more layers of the company's pre-petition debt. In arranging a defensive DIP, the agent of the pre-petition debt must put together a structure amenable to these diverse investors, each of which has its own agenda, investment time horizon, and approach to investing. Even within a single financial entity, multiple branches, divisions, affiliates, or trading desks of an institution may own the company's pre-petition debt and may not view that investment or its potential involvement in a DIP facility in the same light. For example, a large institution may have a commercial loan desk looking to profit from the fees and interest offered on a DIP facility (and to be repaid in cash upon emergence from bankruptcy), while a trader at the same institution who works on the distressed trading desk may be looking for the long-term value associated with a DIP facility that converts into equity upon the company's emergence from bankruptcy (depending, of course, on the restructuring plan's valuation of the reorganized equity and how much upside potential is implied by such valuation).

In addition, the recent boom-and-bust cycle was marked by the growth of high levels of leverage and increased amounts, and often multiple layers, of secured debt. When companies go bankrupt today, they are far more likely than in the past to be facing secured creditors whose claims exceed the value of the company's assets, and multiple classes of secured creditors, all of whom are afforded special protections under the Bankruptcy Code. The growth in the use of secured credit and second (or third, etc.) lien credit leaves many debtor companies with few, if any, unencumbered assets to serve as collateral for their DIP financing. As a result, offensive DIP lending has become more challenging because there is a dearth of unencumbered assets. A debtor attempting to grant *pari passu* or priming liens to offensive DIP lenders faces an often insurmountable challenge from its existing secured lenders to show that these secured lenders will receive adequate protection if the offensive DIP and *pari passu* or priming liens are permitted. To prevent adequate protection objections and litigation, known as a "priming fight," debtors generally favor obtaining defensive DIPs rather than offensive DIPs. (Adequate protection is discussed further below with respect to its role in the bankruptcy court approval process.)

Roll-Up Loans to Incentivize DIP Facility Participation

To incentivize pre-petition secured lenders to participate in the DIP and loan new funds, the company may offer to convert all or a portion of the lenders' pre-petition secured debt into a post-petition claim. The pre-petition debt is deemed to have been "rolled up" into the DIP loan, which is a post-petition obligation of the debtor. The use of roll-up loans, which existed prior to the recent downturn, became common during the recent spate of DIP financings. However, as the credit markets continue to improve, this trend is likely to subside.

Recently, the most common roll-up provision allows pre-petition lenders to roll up $1 of pre-petition debt for each $1 of new money loaned to the company as part of the DIP facility. The conversion of pre-petition debt to post-petition debt provides the lender with the benefit of administrative expense priority in the bankruptcy. The claim on such debt must therefore be paid in full in cash upon the company's emergence from bankruptcy unless the holder of such loan otherwise consents. In short, the claim cannot be compromised in the bankruptcy process. The recent downturn has given us the innovation of "modified" roll-up loans that do not have to be paid in cash in full at the conclusion of the bankruptcy case. Rather, these modified roll-up loans may be "termed out" and become post-emergence debt obligations of the reorganized company instead of being repaid in full in cash with the consent of two-thirds in amount and one-half in number of the roll-up class—that is, the requisite Bankruptcy Code class approval instead of individual lender consent to not receiving payment in full in cash. (For an example of a DIP facility with a dollar-for-dollar roll-up provision, see the term sheet for the Aleris International Inc. DIP facility included as Appendix A.)

Obtaining and Documenting DIP Financing

While every financing situation is different, there are common steps required for obtaining DIP financing: commitment and syndication, commitment documentation, bankruptcy court approval, and the DIP order.

Commitment and Syndication

The process of obtaining DIP financing is not that different from the process of obtaining non-bankruptcy financing. The debtor, in consultation with its financial/restructuring adviser, will engage in discussions with banks and other financial entities to arrange a loan. A company facing liquidity issues and planning to file for bankruptcy should line up its DIP financing well in advance of filing its bankruptcy petition. Because of disruptions in the credit markets and the increased complexity associated with obtaining credit in the current market, companies facing the prospect of a bankruptcy filing should allow greater lead time than in the past to negotiate and obtain DIP loan commitments.

<u>Working Capital Needs and Budget</u>

The debtor and its financial adviser will provide the arranger of the proposed DIP facility with a budget that captures the working capital needs of the debtor throughout the reorganization process (or at least through the maturity date of the proposed DIP facility). Prior to the credit crunch that began in late 2007, the arranger of the DIP financing would usually underwrite the entire DIP facility and, once committed, would then look to syndicate the financing commitment to other financial entities. Recently, however, financial entities that arrange DIP financing are looking to syndicate DIP loans prior to committing to provide the facility as a means of mitigating underwriting risk in uncertain markets.

Defensive DIPs are typically arranged by the agent bank under the debtor's existing pre-petition credit agreement (typically the most senior facility if the debtor has more than one level of credit facility debt). The agent bank will usually put together a steering committee of pre-petition lenders (or such a steering committee will form independently and approach the agent bank) to negotiate and underwrite the DIP facility before including the rest of the bank group in discussions regarding the company's likely bankruptcy filing and the proposed DIP facility.

With the growing inclusion of private equity and hedge fund investors in the bank financing market, companies may be unable to include the entire

pre-petition bank group in their pre-filing DIP financing negotiations, because many of these pre-petition lenders are so-called public-side investors. Public-side investors do not want access to material non-public information, because it would adversely affect their ability to trade in the company's debt or equity securities. Knowledge of a planned bankruptcy filing, or knowledge that a company is attempting to put together a syndicate of DIP lenders, would constitute such material non-public information. The hope of the company, the agent, and the steering committee is that the DIP financing negotiated among them will be agreeable to the rest of the pre-petition bank group and that the rest of the pre-petition bank group (or at least a large portion thereof) will participate in the negotiated DIP financing. Sometimes, once the rest of the pre-petition lenders are made privy to the terms of the DIP financing, usually upon the eve of, or shortly after, the filing of the bankruptcy petition, modifications to the negotiated DIP facility must be made to either get the other lenders to join the DIP financing syndicate or to resolve objections they may otherwise raise at the bankruptcy court hearing required to approve the DIP facility.

Commitment Documentation

The documentation for the DIP facility commitment process looks very similar to that in the non-bankruptcy context. The debtor and the arranger enter into a commitment letter (assuming the facility is underwritten) whereby the arranger agrees to commit to provide the financing on the terms negotiated. These terms are usually contained in a term sheet attached to the commitment letter as an exhibit. If the arranger is not committing to provide the facility, but is only engaged to arrange and syndicate the facility on a "best efforts" basis, then, instead of a commitment letter, there will be an engagement letter setting forth the terms of the arranger's engagement. In addition, in either case, a fee letter will establish the fees to be paid to the arranger. Counsel for the arranger and the debtor negotiate and draft these letters and related term sheets. They then negotiate a credit agreement based on the terms and conditions contained in the term sheet. In exigent circumstances, DIP facilities have on occasion been funded based on the term sheet, with the long-form credit documentation negotiated post-funding (this was the approach taken, for example, in connection with Lyondell

Chemical Company's $8.015 billion DIP facility). Specific provisions of the DIP credit agreement will be discussed in further detail below.

Bankruptcy Court Approval

Although the negotiation and documentation of a DIP facility initially looks a lot like that for a non-bankruptcy credit facility, there are significant differences in the process. DIP financing requires bankruptcy court approval. Bankruptcy court approval necessitates producing a DIP credit agreement that is acceptable not only to the company and the lenders, but also to the U.S. trustee (a component of the Department of Justice responsible for overseeing the administration of bankruptcy cases) and other pre-petition creditors (usually the unsecured creditors, who are represented by the statutory creditors committee), each of whom may object to provisions in the DIP agreement, as well as to the bankruptcy court itself. Such objections, and the desire to avoid objections by negotiating with these parties prior to seeking court approval, often causes what would be a private negotiation between a company and its lenders in the non-bankruptcy context to be transformed into a public struggle between various constituencies in the bankruptcy process.

Two-Part Process for Approval

Bankruptcy court approval is usually a two-step process. The DIP financing motion is typically filed as part of the debtor's "first-day" motions that are filed along with, or soon after, the bankruptcy petition. On the first or second day after the Chapter 11 case is commenced, there is an interim hearing on the DIP financing motion and other first-day motions. At this interim hearing, the debtor seeks authority to borrow under the DIP facility the amount necessary to avoid immediate and irreparable harm to the estate pending a final hearing. Twenty-five to thirty days later, and at least fifteen days later, there is a final hearing on notice to all the parties in interest. See Federal Rules of Bankruptcy Procedure, Rule 4001(c). At the final hearing, the borrower seeks authority to borrow the entire committed amount of the DIP facility.

Substantive Requirements for Approval

To obtain DIP financing that benefits from (i) super-priority administrative expense priority, (ii) a lien on unencumbered property, and/or (iii) a junior lien on encumbered property, the debtor must show that it could not obtain credit on more favorable terms. See 11 U.S.C. § 364(c) (West 2009). To obtain DIP financing that benefits from a priming or *pari passu* lien on encumbered property, the debtor must show (1) that it could not obtain credit without granting such liens, and, (2) unless the pre-petition lien holder consents to the post-petition priming or *pari passu* lien, that there is adequate protection of the value of the pre-petition lenders' liens whose liens will be *pari passu* to, or primed by, the DIP lenders' liens. See 11 U.S.C. § 364(d).

Because the debtor must show that it could not obtain credit on more favorable terms, the debtor will often make inquiries to multiple financial entities regarding such entities' willingness to provide DIP financing and the terms upon which those institutions will provide such financing. At the hearing on the DIP motion, a financial officer of the debtor, often the chief financial officer, or a representative of the debtor's financial adviser, will testify about the steps the debtor took to seek alternative DIP financing to that for which the debtor is seeking court approval in order to carry the debtor's burden on this requirement.

Adequate Protection of Liens

Adequate protection involves the protection of the value of the pre-petition lenders' liens on the debtor's assets. DIP loans are often secured by priming liens on assets of the debtor company. These assets may already serve as collateral for the debtor company's pre-petition debt. Permitting priming liens may cause a reduction in the value of the pre-petition lenders' liens. Therefore, Section 364(d) of the Bankruptcy Code requires that, unless they consent otherwise, primed pre-petition lenders receive adequate protection of their property interest (their pre-petition liens). Adequate protection can take many forms, including cash payments to the pre-petition lien holders (which, in practice, often takes the form of monthly payments to the pre-petition lenders at a rate equal to the interest rate under the pre-petition

debt agreement), additional or replacement liens, or super-priority administrative claims. In addition, the requirement to provide adequate protection can be met if there is a sufficient equity cushion in the collateral—that is, the collateral is worth more than the claims it secures.

To eliminate the need to prove that adequate protection is being provided to the pre-petition lenders, debtors often seek DIP financing from the pre-petition lenders themselves (a defensive DIP). This group of lenders is able to resolve adequate protection issues consensually while they negotiate the DIP facility with the debtor. If the debtor company plans to enter into an offensive DIP, adequate protection issues must be negotiated among the debtor company, the pre-petition lenders, and the DIP lenders. The pre-petition lenders and the DIP lenders have opposing interests, because each wants to benefit from the value of the shared collateral. Defensive DIPs simplify negotiations and court approval by removing a potential second set of lenders from the negotiating process and not giving such lenders a basis for an adequate protection objection at the bankruptcy court approval hearing for the DIP financing. Adequate protection litigation can be expensive and can delay DIP financing approval from the court. Debtors generally do not want to deal with such an issue at the start of their case and therefore often accept financing from their existing secured lenders if offered on market terms even if such terms are not, aside from these other concerns, the most favorable terms available with respect to interest rates, fees, and so on.

Disclosure Requirements

If the proposed DIP financing contains certain provisions that are deemed material by the Federal Bankruptcy Rules (or the local rules of a particular bankruptcy court or bankruptcy court district), the DIP financing motion must expressly disclose the inclusion of such provisions. The provisions that must be disclosed include, among others, the granting of priming liens, the establishment of certain case milestone deadlines, the release or waiver of causes of action belonging to the estate, the waiver of the estate's right to recover the expenses associated with maintaining property securing a claim, and the granting of a lien in favor of the DIP

lenders on avoidance actions belonging to the estate. See Federal Rules of Bankruptcy Procedure, Rule 4001(c).

Closing the DIP Financing—the DIP Order

The DIP financing usually closes after approval at the interim hearing. The scope of the DIP lenders' security is established by the DIP order itself, which, in a secured DIP financing, will provide the DIP lenders with a perfected security interest. That security interest will rank senior, *pari passu*, or junior to existing liens, if any, depending on the nature of the financing. DIP lenders usually require senior liens that prime those of the pre-petition secured lenders. A security agreement is not necessary because the DIP order establishes the security interest, though one is often executed and delivered at the request of the DIP agent to establish a contractual basis for the security interest. In the same vein, Uniform Commercial Code filings are not necessary to perfect the security interest, since such perfection is established by the DIP order itself. However, the DIP agent may prefer that such financing statements be filed to ensure that it takes all steps possible to establish and maintain its perfected priority position. The DIP order will, in such event, modify the automatic stay to permit such Uniform Commercial Code filings. In addition, the DIP order will modify the automatic stay to permit the DIP lenders to exercise remedies in respect of the DIP facility collateral upon the occurrence of an event of default under the DIP credit agreement upon notice to the debtor, the U.S. trustee, and the bankruptcy court.

Credit Agreement Documentation

The DIP credit agreement is substantially similar to credit agreements used in non-bankruptcy financings. The credit agreement contains provisions that include the borrowing mechanics, interest rates, repayment and prepayment terms, representations and warranties, covenants, and events of default. However, the DIP credit agreement will contain some additional provisions and nuances that are not included in the conventional non-bankruptcy credit agreement. (For an example of certain of the credit

agreement provisions below, see the selected sample credit agreement provisions applicable to DIP financing included as Appendix B.)

DIP Credit Agreement Covenants

DIP lenders can exert a degree of control over the debtor and its bankruptcy case through the credit agreement covenants. As in non-bankruptcy credit agreements, violation of a covenant may trigger an event of default under the credit agreement, which requires repayment of the DIP loan prior to its scheduled maturity. Such an event of default could cause major problems for a debtor because the debtor would lose the financing used to fund its operations, which could trigger a loss of confidence by its vendors and customers and thwart the debtor's ability to effectively reorganize, forcing a liquidation of its assets. Certain bankruptcy-specific covenants, such as the asset sale covenant and the bankruptcy milestone covenant, if included, tend to be highly negotiated and can greatly influence the conduct and outcome of the bankruptcy case.

<u>Delivery of Financial Information</u>

Credit agreements, in both the bankruptcy and non-bankruptcy context, contain a covenant requiring the delivery of the company's financial statements. In the DIP financing market, the covenant requiring delivery of financial information is expanded, often requiring the borrower to deliver monthly (and occasionally, weekly) financial statements, as well as thirteen-week cash flow forecasts and reconciliations between the prior thirteen-week cash flow forecast and the actual results of operations. The covenant will also often contain a default provision triggered by a specified percentage variance between projected and actual disbursements or receipts during the applicable period.

<u>Retention of Restructuring Professionals</u>

The DIP credit agreement often requires the company to retain a crisis management and/or restructuring adviser and a chief restructuring officer. This requirement ensures that, in addition to the debtor's

current management, there is an officer of the company, along with advisers, experienced in the implementation of, and focused on, a restructuring plan. This is important to DIP lenders because managing the restructuring process requires a different set of skills and focus than normal business management.

Financial Covenants

The financial covenants with respect to a DIP facility are generally different from those required with respect to a non-debtor borrower. Rather than a leverage test, interest coverage test, or other similar metric, the DIP facility credit agreement will typically contain a minimum EBITDAR covenant, which, in addition to the adjustments made to net income to derive EBITDA (adding back interest, taxes, depreciation, and amortization), adds back restructuring costs in calculating covenant earnings.

Entry of Final Order

Because the DIP credit agreement is generally approved by the bankruptcy court in an interim order, the DIP credit agreement requires the entry of a final order within a set time period following entry of the interim order.

Asset Sale Covenant

Also known as an asset sale milestone, this covenant requires the debtor to sell assets within a specified time period through a Bankruptcy Code Section 363 sale. See 11 U.S.C. § 363 (West 2009). A Section 363 sale allows the debtor, after notice and a hearing and with bankruptcy court approval, to sell assets outside the ordinary course of business. Through the prepayment provisions of the DIP credit agreement, the proceeds of these asset sales are applied to prepay the DIP loans, or reduce the commitments available under the facility. These asset sale milestones have gained increasing popularity during the recent credit crunch as a method to speed the process of repayment of the DIP lenders' loans and, if the proceeds are sufficient, the pre-petition lenders' (who are often the same or substantially the same entities as the DIP lenders)

secured loans. The requirement to quickly sell assets may prevent debtors from reorganizing pursuant to a stand-alone reorganization plan because the debtor must either sell the assets in accordance with the covenant or refinance its DIP facility with a new facility that does not require such a sale.

Opponents of tight asset sale covenants, notably debtors and their counsel, as well as unsecured creditors (and equity holders), who hope a turnaround of the company may lead to greater recovery on their claims or interests, argue that asset sale milestones give the DIP lenders too much control over the bankruptcy process. They further argue that DIP facilities with tight asset sale provisions do not provide debtors with enough time for a true operational restructuring; rather, they provide the company with enough funds to operate while it seeks a buyer. Their contention centers on the fact that such milestones often require the sale of assets in such a short period of time that the debtor and its advisers do not have the time to realistically attempt a turnaround of the company. This control by the DIP lenders (who are often also the pre-petition senior lenders) can be viewed as ensuring a quick return of the DIP lenders' money and some recovery for certain pre-petition senior lenders, but providing no value for unsecured creditors or equity holders.

Bankruptcy Milestones

Another type of affirmative covenant, known as a bankruptcy milestone, has also gained increasing popularity during the recent downturn. Bankruptcy milestone covenants require the debtor to reach certain milestones in its bankruptcy case within a specified time. These milestones generally include the establishment of deadlines for filing a plan of reorganization, for court approval of a disclosure statement, for a hearing on confirmation, and for entry of a confirmation order. This covenant prevents the debtor from allowing the bankruptcy case to extend for a longer time than the DIP lenders would like. Like asset sale milestones, these bankruptcy milestones are designed to ensure prompt repayment of the DIP loans and a swift exit from bankruptcy.

Amendment/Waiver Fees

Restrictive covenants, such as the ones described, may also increase the lenders' ability to obtain amendment/waiver fees from the company and improve the economics of their loan investment. Those representing debtors' interests may argue that DIP lenders have used the tight credit market to impose covenants that they intend to be too restrictive, thus forcing companies to seek future modifications to the DIP credit agreement. If the company cannot meet its covenant obligations, it will need to seek an amendment or waiver of the DIP credit agreement. In return for agreeing to an amendment or waiver, DIP lenders will often require a fee.

Carve-Out for Professionals' Fees

DIP financing agreements also provide a carve-out for professional fees, which permits a certain amount of funds from the debtor's estate to pay the debtor's (and often the creditors committee's) professional fees that would otherwise be paid over to the DIP lenders upon an event of default under the DIP credit agreement. The purpose of this carve-out is to provide that, if an event of default under the DIP facility occurs, the debtor's professionals may be paid prior to the DIP lenders. The rationale for this is that the cost of obtaining the DIP lenders' recoveries should not be borne by the professionals engaged by the debtor. The typical carve-out permits the debtor's professionals to be paid for all work done prior to the occurrence of an event of default under the DIP credit agreement and for a specified sum following the event of default. The amount of the carve-out varies by case and is highly negotiated. The size of the bankruptcy estate and the complexity of the case are major factors.

DIP Credit Agreement Events of Default

In addition to the usual non-bankruptcy credit agreement events of default, DIP credit agreements contain a number of events of default provisions specific to the bankruptcy context. These events of default generally include

dismissal of the bankruptcy case, conversion of the bankruptcy case to a Chapter 7 case (that is, a liquidation case, as opposed to a reorganization case under Chapter 11), the appointment of a trustee, the appointment of an examiner with expanded powers, the failure to obtain a final order of the bankruptcy court with respect to the DIP financing, loss of the debtor's exclusive right to file a plan in the bankruptcy case, and the filing of a plan that does not include the payment of all DIP loans in full in cash upon consummation of the plan.

While it is important for the debtor's counsel to review all the event of default provisions in a DIP credit facility, particular care must be taken when negotiating the financial covenants and, if included, any asset sale covenant or bankruptcy milestones. Because management of the debtor will have a tendency to overestimate the ability of the debtor to meet any specified financial metric, or to achieve an asset sale or other bankruptcy milestone in a timely manner—and the only thing that is certain about the bankruptcy process is uncertainty—debtor's counsel must press hard on management to make sure they are being realistic and that all covenants have sufficient "cushion" to give the debtor enough flexibility to deal with the unexpected. Of course, the DIP lenders, who often have greater negotiating leverage than the debtor, will not want to give the debtor too much leeway, but it is not in either side's interest to have "tripwire" covenants, so careful analysis needs to be done on both sides.

Another important consideration for the debtor's counsel to keep in mind is communication. In almost all cases, a debtor will be best served by having an active dialogue and transparent sharing of information with its DIP lenders. The DIP lenders will generally be much more favorably inclined to granting an amendment or waiver that the debtor needs if they feel like the debtor has been open and honest with them throughout the Chapter 11 process.

Conclusion

Debtors needing to raise DIP or exit financing during the past twelve months have faced a particularly challenging environment. For a time,

the DIP financing market was essentially closed, and DIP financing, if available at all, was only available on quite expensive and restrictive terms. Because obtaining DIP financing may be a "life or death" issue for many companies, this freeze in the credit markets had a substantial adverse impact on companies in financial distress facing a possible Chapter 11 filing.

In recent months, the DIP financing market has begun to show signs of life, but challenges remain. While certain innovative features such as the dollar-for-dollar roll-up of pre-petition loans to incentivize lenders to participate in a DIP facility may fall by the wayside as the credit markets improve, asset sale covenants and bankruptcy milestones will likely remain a part of DIP financing for the foreseeable future.

Bankruptcy and financing lawyers and financial professionals working with clients to obtain or arrange DIP financing should advise their clients to begin the DIP commitment process as early as possible, particularly when the company involved will require a large DIP facility. It is more complicated to arrange DIP financing in today's markets, and it is critical to allot extra time for the process. Myriad issues may arise throughout the DIP financing process due to the increased number and different nature of participants in the DIP loan market, so it is best to start early.

In volatile credit markets, it is more important than ever to have experienced professionals that are able to guide clients through the financing and bankruptcy process. The most effective counsel not only knows the law and the process, but has a good feel for the market dynamics, as market forces play a large role in dictating the terms of any DIP financing.

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Mr. Zumbro received a B.A., cum laude and with distinction in the major, from Yale College in 1992. In 1997, he received a J.D. from Columbia Law School, where he was a Stone Scholar. He is a member of the International Bar Association (IBA) and the American Bankruptcy Institute. He co-authored the United States country section in the Practical Law Company's Cross-Border Finance Handbook: Secured Lending *(2006–2007 and 2008–2009), and he has been recognized by* The Legal 500 *for his skill in the national bank lending arena. In May 2009, Paul co-chaired a panel entitled* "Know your counterparty - learning lessons from the credit crunch" *at the IBA's 26th International Financial Law Conference in Rome, Italy. More recently, Paul gave a seminar presentation at the Loan Syndications and Trading Association entitled* "Section 363 Bankruptcy Sales: Is There a New Trend That Could Undermine Creditors' Rights?" *and authored a LexisNexis Emerging Issues Analysis* "Paul H. Zumbro on In re Chrysler LLC". *His paper,* "Cross-Border Insolvencies and International Protocols - An Imperfect but Effective Tool" *will appear in the May 2010 issue of the IBA's* Business Law International.

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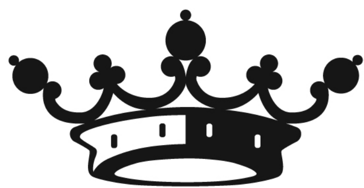

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