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Recent Trends in Debtor-in-Possession Financing

Leading Lawyers Analyze Bankruptcy Financing

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DIP and Exit Financing Trends and Strategies in a Changing Marketplace

Paul H. Zumbro

Partner

Cravath, Swaine & Moore LLP

ASPATORE

Introduction

In Chapter 11, inaction can be fatal—to achieve a successful reorganization, a company heading toward bankruptcy must act and must act quickly to avoid a liquidation or otherwise value-destroying outcome. Although many pressing issues may vie for the attention of the management of a company in distress, one of the most important tasks of any potential debtor is obtaining necessary bankruptcy financing. Such financing, known as debtor-in-possession or "DIP" financing, facilitates the reorganization of a "debtor-in-possession" (i.e., the company after it has filed a bankruptcy petition) by providing it fresh capital to fund its business during the pendency of the bankruptcy case. Obtaining DIP financing is also an important signal to the market, as vendors and customers will want assurances with respect to the reliability of the debtor's ongoing payment capacity and the ability of the debtor to remain in business during the reorganization process. Showing that sophisticated lenders have examined the debtor's finances and believe in the debtor's ability to repay its post-petition obligations (and are thus willing to provide DIP financing) goes a long way to quell these worries, enabling the debtor to continue operating as a going concern while it pursues a reorganization.

The policy of favoring corporate reorganization over liquidation animates Chapter 11. DIP financing is an integral step toward achieving that policy goal in any given case, and keeping current on the legal and other trends relating to this important segment of the financing market is crucial for any counsel practicing in this area.

Recent Trends and the Regulatory Environment Affecting Debtor-in-Possession and Exit Financing

The broader economic environment always has a major impact on DIP and exit financing trends. Currently, we are seeing a lot of DIP financings in the oil, gas and other energy sectors as a result of a pronounced and sustained decline in commodity prices, particularly oil and gas prices. There is a growing need for DIP financing in that area—but obtaining that financing can be challenging because asset valuations are declining or fluctuating rapidly. Such rapid changes in valuations lead to uncertainty about where the value line breaks—i.e., about which creditor group holds the "fulcrum security" and will be entitled to the new equity of a reorganized company. For example, I worked on a recent oil and gas case where it appeared that the second lien bondholders would have the fulcrum security in the reorganization at the outset but, as a result of the dramatic decline in oil and gas prices, the second lien was wiped out, the first lien suffered significant losses and even the DIP loan was impaired by the time the case concluded. This type of uncertainty regarding valuations makes potential DIP lenders understandably more cautious about extending DIP financing than they would be in a more stable market environment.

Uncertainty is not unique to the current environment, but the pronounced and sustained decline in commodity prices over the past 12-plus months has been rather stark and has had a wide-ranging impact not only on oil and gas companies but throughout the economy and financing markets. Although the decline in commodity prices began more than a year ago, we had not fully felt those declines prior to 2016, as many oil and gas companies had hedging arrangements in place that locked in higher commodity prices (and related cash flows) and allowed them to mask liquidity issues for a good part of 2015. As those hedges have rolled off, the actual impact of the decline in commodity prices is now being felt much more acutely.

In terms of the regulatory environment, the leveraged lending guidance that was issued by the Federal Reserve and other bank regulators, which has had a significant impact on leveraged financing in general, has also affected the DIP financing area in ways the regulators may not have intended. The guidance states that it is not intended to "discourage" DIP financing,[1] but given how broadly the guidance is written, it unfortunately may do so in practice. For instance, the guidance contains some provisions relating to so-called "fallen angels" (i.e., companies that previously were investment grade but whose financial condition has deteriorated significantly), which states that unless a lender can clearly show how the extension of new credit or funds to such a company mitigates risk, the new loan will receive an adverse

[1] With respect to DIP financing, the guidance states the following: "Nothing in the preceding [underwriting standards section] should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code." BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE AGENCY & OFFICE OF THE COMPTROLLER OF THE CURRENCY, INTERAGENCY GUIDANCE ON LEVERAGED LENDING (2013).

risk rating. This is a challenging concept to apply in the context of DIP financing. While it is true that the main reason banks provide DIP financing is to protect their existing credit exposure and to thereby maximize their recovery in a situation where the borrower's business has not performed well, this involves complex analysis in the context of often quickly changing circumstances that make it exceedingly difficult to "clearly" demonstrate risk mitigation. Imposing an additional layer of regulatory oversight with respect to credit exposures that banks are unquestionably economically motivated to protect does not make a lot of sense—and it is not the circumstance that the leveraged lending guidance was intended to address. However, because government regulators have been so vocal in their efforts to ensure that banks comply with the leveraged lending guidance, banks are quite sensitive to compliance issues and thus tend to err on the side of caution.

For example, I recently worked on a DIP financing matter where my client did not have any economic exposure with respect to the credit; it was the agent under the pre-petition facility, but the secured lenders were really controlling the situation and driving the process because they had all the economic exposure. The secured lenders asked my client to be the agent under the DIP facility that the lenders were providing, because they sought continuity in terms of the agent's role, and because as pre-petition agents we could help coordinate the process. Even though the agent had no existing economic exposure and it was not incurring any new exposure, acting as agent under the DIP facility was viewed as an "origination" for the purposes of leveraged lending guidance compliance. Accordingly, the agent had to go through a very extensive credit approval process that put pressure on its ability to execute in a timely manner—and timeliness is quite important in a bankruptcy scenario. The agent was ultimately able to obtain the credit approval it needed, but the overhang of the leveraged lending guidance on the process added considerable stress to an already stressful situation, with no regulatory benefit. The interplay between the leveraged lending guidance and DIP financing is an issue that requires further scrutiny and discussion between regulators and practitioners to provide additional clarity to debtors and lenders or agents contemplating participating in DIP financing, ideally (although probably unlikely) by the regulators replacing the statement of "non-discouragement" of DIP financing with a clear exemption for DIP financing.

Emerging Challenges for Clients Seeking Debtor-in-Possession or Exit Financing

Unlike the situation in years past, when the agent would have meaningful economic exposure under a borrower's main credit facility and would typically work with a relatively small group of commercial bank lenders in a workout or other distress situation, there has been a significant increase in the number of institutional lenders (hedge funds, CLOs, etc.) in the leveraged lending space, resulting in both a greater number of lenders and a different type of lender. The pre-petition lenders are the most natural providers of DIP financing, but the pre-petition lender group is often a widely dispersed group of institutional investors these days, with the agent/arranger bank having syndicated most (if not all) its credit exposure. When there is a very widely held pre-petition facility, and if the agent bank has little or no credit exposure (and thus no economic motivation to play the "quarterback" role agent banks had traditionally played in distress situations), arranging a DIP financing can be very difficult both from a timing and an overall execution perspective. While the pre-petition lenders may be willing to provide DIP financing to protect their existing exposure, it is often the case that no individual lender will have a sufficiently significant economic exposure to be interested in coordinating, arranging, and structuring the DIP financing package. In short, the trend toward the dispersion of financing outside of bankruptcy means that companies in need of DIP financing must increasingly deal with a large group of institutional investors (motivated primarily by investment yield), as opposed to the handful of banks with whom the company has had an ongoing relationship. This continuing trend makes it challenging for debtors to put together a DIP financing package as quickly as they often need to.

Key Providers of DIP Financing

Historically, DIP loans were structured as revolving credit facilities, which allowed the debtor to borrow and repay as needed during the course of the bankruptcy case. That was a great arrangement from a debtor's perspective, as it allowed the debtor the greatest amount of flexibility and the ability to manage interest expense by actively managing borrowings to keep funded amounts (and associated borrowing costs) as low as possible. However, institutional lenders, which make up an increasingly large portion of the lenders in the leveraged finance market, are typically unable or unwilling to provide revolving credit facilities. This trend means that DIP loans are increasingly structured as term loans, which are fully funded throughout the case. As a result, more borrowings may be outstanding, which leads to higher interest expense. But the more important issue from the debtor's perspective is that the institutional loan market typically demands higher pricing than the revolving credit market.

Institutional lenders look for yield, and they want funded assets (i.e., term loans). They do not want unfunded revolving lending commitments for a variety of reasons, including their tax status. Many institutional investors rely on the portfolio interest exemption, which allows them to avoid having to pay U.S. income taxes on income derived from investments in funded assets. There are also tax issues related to being "engaged in a trade or business" associated with commitments to lend (as opposed to investments in funded asset sales) that are important to many institutional lenders. Accordingly, the institutional lenders—which increasingly drive the market—frequently demand a term loan structure to provide DIP financing. As a result of the continued trend toward term loan structured DIPs that are designed to be syndicated to institutional investors as opposed to more traditional revolving credit facility DIPs, DIP financing has become more expensive for debtors.

Changes in the Credit Markets and Impact on DIP Financing

DIP financing is all about pricing and risk. Once a deal goes into a workout, the best possible result for lenders is a par recovery. The lenders are not equity investors; if the company turns around and hits a home run, the lenders will not profit from that outcome. Instead, lenders tend to try to manage their exposure in ways that are mindful of the credit markets. Even in tight credit markets, though, for certain debtors—those which can demonstrate to their lenders that continued funding will preserve and protect going concern value, and who have carefully thought through what they hope to accomplish through the restructuring and how they plan on exiting bankruptcy—DIP financing will be available.

Something I am seeing today, however, is banks seriously considering whether, in certain circumstances, a liquidation might be a better outcome than putting additional capital at risk through DIP financing. This is surprising for two reasons: first, going concern value is almost always higher than liquidation value, and second, DIP loans should be "money good." As a general matter, a DIP loan should be a safe investment, because it has the protections of the Bankruptcy Code, the super-priority lien, and the super-priority claim (section 364 of the Bankruptcy Code permits a DIP lender to obtain lien and claim status in the case that trumps all other liens and claims).[2] Also, a DIP loan cannot be crammed down; a debtor must pay it off in cash to confirm a bankruptcy plan. Therefore, a DIP loan should ordinarily be a safe deployment of capital.

Given the current economic and market environment, though, banks and other lenders are increasingly asking themselves the difficult question, in light of both company-specific circumstances and also larger trends: Does it make sense to just liquidate the company? In a liquidation scenario a bank will, hopefully, get its money back, as there usually should be enough value to cover the senior secured lenders. In a rapidly declining asset value environment, though, lenders may be motivated to capture that liquidation value to ensure a par recovery (or at least lock in a level of losses) rather than taking the risk of providing additional financing in an effort to capture going concern value. Because DIP lenders do not share in the upside of a recovery, liquidation might be preferable to providing DIP financing in an uncertain environment. In most cases, the lenders ultimately conclude that it is better to provide DIP financing to preserve a company's going concern value (and thus maximize the lenders' prospects for a par recovery), but it is certainly interesting that in today's market, many lenders are struggling to decide whether it really makes sense for them to be DIP lenders even in cases where they have significant existing pre-petition credit exposure.

Impacts of the Economic Recovery on Recent Lending Strategies

The (slow-paced) economic recovery has been going on for so long that it is hard to point to any specific recent effects of that recovery on lending strategies. Companies always need financing, and banks make money by either providing or arranging financing for successful companies or companies that show potential. As such, there will always be financing

[2] 11 U.S.C. § 364(d) (2012).

available for the right companies. Indeed, we are very fortunate to have extraordinarily well-functioning capital markets in the United States.

But disruptions do happen. Banks and other lenders sometimes make mistakes, and financing is offered to the wrong company—a company with a poor business plan or too much leverage (i.e., too much debt compared to cash flow). Typically, a company ends up in bankruptcy for one of two reasons—it either has a bad business plan or a bad balance sheet. Often, it is a combination of the two (frequently coupled with poor management). In some cases, the company is in an industry where secular or technological changes have taken place that make the business no longer viable. (Remember renting video cassettes from Blockbuster Video? I do, but the notion of driving to a store to rent a movie is completely alien to my children. And yes, Blockbuster went through bankruptcy a few years ago.)

Notwithstanding firm-specific or market disruptions, there will (almost) always be lenders willing to provide capital to companies that need capital—and a well-functioning capital market provides a way for those two groups to find each other. Of course, in times of market disruption, banks and other providers of capital will take a more conservative approach in terms of slowing down lending for some period of time. But banks are in the business of making money, and once an economic crisis has passed they will go back to lending. A period of slow and steady economic growth is not necessarily a bad environment for bank lending; rather, banks generally retreat from lending during periods of significant market volatility—major disruptions tend to impact the availability of capital, and the market for DIP financing is no exception to that rule—but they return quickly as the economic waters calm.

Recent Legal Decisions and Trends Affecting DIP Financing Practices

The leveraged lending guidance is having a major effect on the leveraged lending market in general, as well as what I believe is an unintended adverse effect on the ability of regulated banks to participate in the DIP financing market. However, most of the trends that we are seeing in this area are driven more by commodity prices, asset valuations, and changes in market participants (i.e., institutional lenders versus the more traditional commercial banks) than any particular law or public policy.

That said, new case law and other trends prevalent in the bankruptcy courts may also have a big effect in certain sectors, particularly with respect to the large and growing number of oil and gas company bankruptcies. For example, there have been some very interesting cases involving oil industry exploration and production (E&P) companies and pipeline companies. A significant amount of capital investment is required to create the infrastructure that is needed to get oil from the wellhead to the refinery, and then to market. Consequently, E&P companies will often sign long-term distribution contracts with pipeline companies that have guaranteed volumes or other provisions that are designed to allow the pipeline companies to recoup the significant upfront investment that is required to put that infrastructure in place. However, when an E&P company winds up in bankruptcy, the company may find itself saddled with a very expensive distribution contract. Let us say, for example, that an E&P company is scaling down its operations because it is in bankruptcy (or pre-bankruptcy financial distress); it may be shutting down some of its wells because, due to the current price of oil, those wells are no longer economically viable. Nevertheless, it may have a contract with a pipeline company that says in effect, "We guarantee that we are going to send you X volume of oil, and we are going to pay you based on X volume even if we don't actually produce X volume of oil." An E&P company may find such a contract quite burdensome in bankruptcy, and in fact, many E&P companies are trying to reject these types of contracts. Certainly, one of the most important tools that the debtor has in bankruptcy is the ability to reject unfavorable contracts. However, many pipeline companies are saying, "Wait a minute—we invested a lot of capital in this infrastructure and these contracts 'run with the land.' You cannot reject them." The pipeline companies are taking the position that the distribution contracts are so integral to the oil fields they serve that they constitute a form of real property right, and accordingly, cannot be rejected as an executory contract by the E&P debtor.

This was a key issue in the recent *Sabine Oil*[3] bankruptcy case. In that case, the bankruptcy judge allowed the E&P debtor to reject its contract with a pipeline company, but left open the possibility that a state judge might have a different view and noted that the Supreme Court of Texas had not

[3] *In re Sabine Oil & Gas Corporation*, Case No. 15-11835 (SCC) (Bankr. S.D.N.Y. July 15, 2015).

addressed the issue (contract and property rights are generally determined in bankruptcy cases under applicable state non-bankruptcy law). Many of the issues in these cases are driven by the laws of Texas and other oil-producing states. Consequently, there is a fair amount of continuing uncertainty as to how these cases will be resolved.

Another key case involving this issue is *Quicksilver*.[4] The debtor in that case had over $2 billion in debt and agreed, in exchange for $245 million, to sell substantially all its domestic U.S. operating assets in a Bankruptcy Code section 363 sale.[5] The purchase agreement, however, is conditioned on the debtor's ability to reject its burdensome distribution contracts. Whether the debtor may do so is currently under the consideration of the bankruptcy court, but the stakes are high: the next highest (unconditioned) bid was over $150 million less than the conditioned bid. So, the court's decision on that one issue will have a huge impact on the level of recoveries that Quicksilver's creditors will receive in the case.

A more general issue that continues to be a hot-button topic in the bankruptcy courts and the DIP financing market is "roll-ups." A roll-up entails pre-petition debt being deemed to be issued (i.e., rolled up) into the post-petition DIP loan facility. Frequently, pre-petition lenders will take the position that the only basis upon which they will provide a DIP facility is if the debtor "rolls up" the lenders' pre-petition debt. That means that, among other protections, the pre-petition debt cannot be "crammed down" (meaning that it has to be paid in full in cash and the lenders cannot be forced to accept take-back debt, thus allowing the lenders to avoid the below-market interest rate risk associated with take-back paper as was seen in the *Momentive*[6] decision). The lenders may be willing to provide new capital to the company but they want to have their pre-petition debt treated like post-petition debt. Some courts are more willing to allow this than others, and sometimes it depends on how much actual new money the lender is making available to the debtor-in-possession. For instance, if the lender is saying, "We want to roll up $10 of pre-petition debt for each 50

4 *In re Quicksilver Resources Inc.*, Case No. 15-10585 (LSS) (Bankr. D. Del. Mar. 17, 2015).
5 *See* 11 U.S.C. § 363.
6 *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D. N.Y. 2014), order aff'd, 531 B.R. 321 (S.D. N.Y. 2015).

cents of new money we put in," it might be hard to get the judge to approve that arrangement. On the other hand, if the lender is seeking a dollar-for-dollar roll-up or is refinancing a pre-petition asset-based lending (ABL) facility that is clearly oversecured with a new DIP ABL facility, it is much more likely the bankruptcy court will approve the roll-up. Particularly in an ABL-to-ABL roll-up, it is hard to see how any unsecured creditor would be harmed, as the only variable is timing, not certainty, of repayment. That is because, to the extent the pre-petition ABL facility is "in formula," it is by definition oversecured, and secured creditors are entitled to the full value of their collateral as a matter of black-letter bankruptcy law. Even though it is usually relatively easy to show that an ABL facility is oversecured, in a bankruptcy scenario, different creditor constituencies may object to various things to further their own interests—and the roll-up issue continues to get a lot of attention. Of course, like a lot of things in the bankruptcy world, much depends on what jurisdiction the case is in and which judge is presiding.

Strategies for Lining Up DIP Financing Before Filing Bankruptcy

The management and equity owners of a struggling company often struggle to accept the reality that bankruptcy may be necessary based on a company's circumstances. This managerial wavering and delay can be a major problem, because it is important to start preparing for filing bankruptcy as soon as possible, as the process takes a lot of time.

For example, a significant amount of work goes into structuring and sizing a DIP facility. In consultation with prospective DIP lenders, the debtor and its financial advisor must prepare a detailed "DIP budget," which typically includes a comprehensive forecast of receipts, disbursements, expenses and net cash flow for rolling 13-week periods. In preparing the DIP budget, the debtor must carefully scrutinize its cash inflows and outflows during the anticipated pendency of the Chapter 11 case, including forecasting the timing of payment of vendors and professional fees, any seasonal variations in its receipts, essential capital expenditures during the period, and the impact of the Chapter 11 case itself on the foregoing. Once a DIP budget has been agreed upon, the debtor and lenders will negotiate the appropriate size and structure of the DIP credit facility to provide the debtor the liquidity required to restructure while holding the debtor to its cash flow projections.

Unlike credit facilities outside the bankruptcy context that may include financial covenants based on total leverage or interest coverage ratios, financial covenants in DIP credit agreements are customarily closely tied to the DIP budget itself, requiring that the debtors' disbursements, receipts and/or net cash flow not vary adversely from the agreed upon projections by a negotiated percentage (often in the range of 10 to 20 percent). Other formulations of financial covenants in DIP credit agreements that drive at the same purpose may require that monthly EBITDA meets, or capital expenditures do not exceed, the agreed upon projections. DIP credit agreements typically provide a mechanism for the 13-week projections to be updated on regular intervals by the debtor, with lender approval, as the Chapter 11 case proceeds, allowing for the credit agreement to adapt to the facts and circumstances of the case over time. In the event that receipts, disbursements or cash flow vary beyond the levels permitted by the credit agreement, however, an event of default would be triggered, bringing the debtor and lenders to the table to determine the appropriate remedies for the DIP lenders (and, more broadly, whether a viable path forward for the company exists). Because noncompliance with the budget variance covenants in a DIP credit agreement can lead to the acceleration of the DIP credit facility—thereby depriving a debtor of its key source of liquidity and signaling to the market that the debtor may be headed toward liquidation—it is imperative that the debtor and its financial advisors carefully consider and discuss with the DIP lenders all foreseeable variables during the anticipated DIP period and structure the DIP facility accordingly.

In addition, DIP facilities often include non-financial "milestone" covenants that require the debtor to make progress toward a successful reorganization and emergence from bankruptcy. In parallel to the discussions about the financial terms and covenants contained in the DIP credit agreement, the debtor, along with its financial and legal advisors, must discuss with the DIP lenders and agree upon appropriate deadlines with respect to the Chapter 11 case. Some examples of case-related milestones include the filing, solicitation, and approval of a plan of reorganization and approval of the related disclosure statement. Depending on the case and circumstances applicable to the debtor, a DIP facility's milestones may also provide that if the reorganization plan-related milestones are not met, the debtor is required to begin a process to, and continue to make progress toward, a sale of all or substantially all of its assets under Section 363 of the Bankruptcy Code.[7] The debtor will push to have maximum flexibility in the milestone timelines, while DIP lenders generally prefer tighter milestones to provide assurance that the case will continue to progress toward an event where the DIP facility is repaid. Unsecured creditors will often oppose any milestones because they may benefit from a longer case that allows valuations to recover.

As noted above, a lot of work goes into putting together a DIP facility, and hopefully the debtor has controls and processes in place that will allow it to gather relevant information quickly. The level and detail of reporting that a DIP lender will require is almost certainly more extensive and of a different nature than the type of financial reporting that companies are used to providing to their lenders outside of bankruptcy. For instance, many non-DIP credit facilities require only quarterly and annual financial statements, and the borrower may be required to have conference calls with lenders only on a quarterly basis. However, the frequency of reporting, and the degree and detail of the reporting and budgeting process, is much greater when moving from a non-DIP facility to a DIP facility. Company CFOs are generally not accustomed to providing the frequency of reporting and level of detailed information required by DIP lenders. Therefore, it is critically important for distressed companies to get started early on that process.

In light of the discussions with potential DIP lenders and the increased reporting requirements during the pendency of a bankruptcy case, it is important to get restructuring professionals involved early on in the bankruptcy process, particularly financial and legal advisors. These experts can help a company and its management team, who may never have gone through this process before, navigate these often murky waters. Financial and legal advisors can greatly help a company prepare for what is usually a challenging transition from "borrower" to "debtor".

New Techniques for Securing DIP Financing

The tried and true techniques that borrowers employ for securing non-DIP financing—i.e., taking advantage of competitive dynamics and not sharing too much information about what other lenders are (or are not) willing to

[7] 11 U.S.C. § 363.

provide—tend to be the best for DIP financing as well. Despite the distressed dynamics, debtors have to keep potential lenders on their toes to obtain attractive offers of DIP financing.

Fortunately for companies entering bankruptcy, a competitive process is embedded in the Bankruptcy Code, and debtors are required to use that process to their advantage in an effort to get the best loan terms available. That means that debtors can and should take advantage of the uncertainty of the situation and the competitive dynamics of the DIP loan process by "puffing" the likelihood of obtaining or the attractiveness of competing proposals—common negotiating techniques for companies seeking the best deal available in the market.

Required Documents for Securing DIP Financing

The DIP financing negotiation process usually moves very quickly, because all parties have to move toward a filing date (which is often triggered by a specific event, like the expiration of the grace period relating to a missed interest payment). In a normal loan transaction scenario, a borrower ordinarily would not expect to receive a loan without a fully negotiated and signed credit agreement and fully implemented security arrangements. While a closing may need to happen on a certain day for accounting or other reasons, there is usually plenty of time to prepare and get all of the loan documentation in order. A DIP loan can be quite different because it typically involves a competitive dynamic coupled with often intense timing pressure. While the debtor normally works with its pre-petition lenders because doing so makes the most sense (the existing lenders not only require less time to conduct diligence than a new lender because of their familiarity with the debtor's business and the collateral package, but also have the incentive to protect their existing credit exposure), the Bankruptcy Code, as noted above, requires the debtor and its financial advisors to shop around in the marketplace to get the best available financing. But the requirement to conduct such an open and competitive lending process before the filing date is a lot to fit in a small window of time. Accordingly, the debtor and its lenders may not have sufficient time to fully negotiate a new credit agreement, and the lenders may be forced to fund without a fully documented credit facility.

DIP lenders are sometimes willing to initially fund on the basis of only a detailed term sheet and an interim financing order. The debtor and the lenders will then use the 30-day period between the interim hearing and the final hearing to get completed credit facility documentation in place (often combining all credit, security, and guaranty documents into a single agreement to ensure that the court is asked to approve only a single document). For example, in the *Lyondell*[8] DIP financing, which was in the $8 billion range, the lenders funded some $2.5 billion in early stage funding using only a term sheet with a DIP budget test and an interim financing order, and then went on to draft and negotiate a full credit agreement. The reason that lenders are willing to proceed in this manner is that, unlike a financing outside of bankruptcy, DIP lenders benefit from the protections of the DIP financing orders, which provide the DIP lenders with an automatically perfected lien on all the collateral specified therein. In addition, section 364(e) of the Bankruptcy Code prohibits appellate courts from invalidating any debt incurred or liens granted in any financing order so long as the lenders extended credit "in good faith."[9]

Key Factors Lenders Look to When Financing a Debtor-in-Possession

When deciding whether to finance a debtor-in-possession, lenders look at a combination of business plans (and prospects) as well as a big-picture plan for the bankruptcy case. Lenders do not want to fund a so-called "free fall bankruptcy."

The debtor's big-picture plan (and having lenders understand such plan) is crucial. Lenders want to ensure that the debtor has thought through what it is hoping to accomplish by filing for reorganization, and how it plans to get from point A to point B—recognizing that the plan will evolve as facts develop during the course of the case. Any debtor approaching potential DIP lenders without having a good idea of what it is hoping to accomplish will not send a good signal to such DIP lenders. Indeed, to the extent a debtor does not have a good story to tell its prospective lenders—a story that has been as thoughtfully crafted as possible given the circumstances—obtaining DIP financing becomes more difficult and a liquidation grows more probable.

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[8] *In re Lyondell Chemical Co.*, Case No. 09-10023 (REG) (Bankr. S.D. N.Y. 2009).
[9] 11 U.S.C. § 364(e).

That said, lenders are pragmatic and understand that the bankruptcy process moves very quickly. If a debtor has gotten professionals involved early on in its case, and has given some thought to what it needs to accomplish with its DIP financing—i.e., thoughtfully considering the path from petition to DIP loan repayment—then that will go a long way toward giving lenders comfort about providing additional financing.

Converting DIP Financing into Exit Financing

Normally, the DIP financing is "converted" into exit financing by paying off the DIP loan and then putting in place a new exit financing arrangement suitable for the emerging company's needs and debt service capacity. Before the bankruptcy exit plan is approved and ready to be implemented, the debtor should, in the meantime, line up its exit financing. In many cases, the same lenders that provide the DIP financing will provide exit financing, but the debtor usually pays off the DIP loan in cash and then enters into a new exit facility—which, hopefully, is structured appropriately in light of the debt capacity of the reorganized entity in terms of leverage and interest rate. The worst outcome is ending up with a so-called "Chapter 22" (a Chapter 11 followed by another Chapter 11) by incurring too much debt at the exit financing stage. Simply put, exit financing should be structured in a way that will allow the reorganized entity to succeed.

Occasionally, a DIP financing arrangement will have a mechanism that allows it to convert directly into exit financing. As a general matter, though, lenders want to have their DIP loan paid off in cash and to make a new credit decision with respect to exit financing, weighing the various factors that lenders (and their credit committees) ordinarily consider in the non-bankruptcy context (e.g., cash flow projections based on contractual and other arrangements in place at exit, downside scenarios, etc.). Because a lot can happen during the course of the bankruptcy case that can impact the credit analysis, lenders will typically resist the notion of having the DIP loan being hardwired to convert into an exit facility unless there are very good reasons to do so in the particular circumstances of a particular debtor.

Common Challenges of the Debt Reorganization and Financing Process

A lot of information emerges during a bankruptcy case, and debtors and lenders alike need to be prepared for the unexpected. To this point, understanding the motivations of the various creditor and other interest groups involved in the case and the capital structure of the debtor is critical. Once again, it is essential to have skilled professionals involved early in the case—advisors who can help navigate the often turbulent waters of a Chapter 11 case.

Conclusion

I began this chapter by noting that a debtor approaching bankruptcy must act quickly to obtain DIP financing. This is truer now than ever before, as DIP financing (like non-bankruptcy financing) has moved toward institutional investors who tend to be more difficult to coordinate and less forgiving than the relationship banks they replaced. Adding further complications, at least in the case of recent bankruptcy filings in the energy space, rapid price fluctuations can transform even promising reorganizations into fire sale liquidations.

All of the above means that understanding how DIP financing works and where the trends are leading is necessary for advising companies confronting difficult times. DIP financing remains the *sine qua non* to Chapter 11, and it is more important than ever to have experienced professionals who can guide clients through the complex and fast-paced DIP financing process. Counsel who know the law and understand the shifting market dynamics will continue to find success in this deeply fulfilling practice area.

Key Takeaways

- Prepare for filing bankruptcy as soon as possible. A lot of work goes into structuring and sizing a DIP facility. The debtor will need to provide detailed forecasts of cash disbursements and receipts, capital expenditure and other budgeting, and an analysis of critical vendors and suppliers.
- Make sure someone in the company has thought about what its real cash needs are, where its receipts are coming from (including foreign suppliers who may be unfamiliar with the Chapter 11 process), what the seasonality is in relation to its cash flow, and if a

certain DIP size is large enough for the expected length of the case. For example, what are the assumptions with respect to the company's income, and does the company have arrangements in place pre-petition that may not be available post-petition (such as factoring arrangements) that would have an adverse impact on liquidity?

- Get restructuring professionals involved early on in the bankruptcy process, particularly financial and legal advisors—experts who can help the company and its management team, who may never have gone through this process before, navigate these murky waters.
- Make sure that DIP lenders understand the company's reorganization plan. Lenders want to make sure that the debtor has thought through what it is hoping to accomplish by filing for reorganization, and how it plans on getting from point A to point B.
- Use the competitive process that is embedded in the Bankruptcy Code to the company's advantage to get the best loan terms available. Capitalize on the uncertainty of the situation and the competitive dynamics of the DIP loan process by "puffing" the likelihood or the attractiveness of competing proposals.
- Note that although it is ideal to sign a credit agreement prior to filing, a DIP loan can be made on nothing more than a detailed term sheet and the interim bankruptcy court approval order, if necessary.
- Line up exit financing before the bankruptcy exit plan is approved, because the proceeds of the exit financing are needed to pay off the DIP financing. Structure exit financing in a way that will allow the reorganized entity to succeed.
- Be prepared for the unexpected. Try to understand the motivations of the various creditor and other interest groups that the company will need to deal with during the course of the case in light of the company's capital structure and other relevant circumstances (e.g., pension obligation issues, other regulatory issues, etc.).

Paul H. Zumbro, a partner in the Corporate Department of Cravath, Swaine & Moore LLP, serves as the Chair of the Firm's Financial Restructuring & Reorganization practice. His practice focuses on restructuring transactions and related financings, both in and out of court, as well as bankruptcy M&A transactions. Mr. Zumbro's practice also includes advising corporate clients on bankruptcy issues and on secured creditor rights in a variety of contexts. He regularly represents agents and arrangers in debt restructurings and debtor-in-possession (DIP) financings, and his debt restructuring experience includes work in the fields of municipal and sovereign debt restructuring. Mr. Zumbro also has extensive experience in non-distressed leveraged finance, having represented the arranger banks in several multibillion-dollar LBO financings. He acts on the borrower side as well, representing sponsors and borrowers in acquisition and non-acquisition related credit facilities.

Mr. Zumbro is a member of the International Bar Association (IBA), a member of the IBA's Banking Law and the Insolvency, Restructuring and Creditors' Rights Committees, and a member of the American Bankruptcy Institute. He co-authored the United States country section in the Practical Law Company's Cross-Border Finance

Handbook (2006/07, 2008/09, and 2011) and has authored several pieces relating to DIP financings.

Mr. Zumbro has been recognized as a leading lawyer in banking and finance by The Legal 500 in 2009, 2012, and 2013 and IFLR1000 from 2013 through 2016. He has also been cited by The Legal 500 for his skill in corporate restructuring from 2010 through 2012.

Mr. Zumbro received a BA cum laude and with Distinction in the Major, from Yale College in 1992 and a JD from Columbia Law School in 1997, where he was a Stone Scholar. Mr. Zumbro joined Cravath in 1997 and became a partner in 2005.

Acknowledgment*: Thanks to Gregory Beaton, Sharon Freiman, and Samuel Niles, associates at Cravath, Swaine & Moore LLP.*

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