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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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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Introduction

I am a partner in the Cravath, Swaine & Moore LLP's restructuring and corporate departments. My practice focuses principally on representing secured creditors in complex in-court and out-of-court restructurings, and draws on my extensive experience in leveraged finance. Prior to transitioning over to a full-time restructuring practice, I had represented the financial sources in many of the most significant and complex leveraged buyout (LBO) financing transactions over the past several years. Following the collapse of the credit markets, I advised the financing sources in a number of high-profile LBO transactions that encountered difficulties or collapsed, including the multibillion-dollar proposed acquisitions of United Rentals, Alliance Data Systems, Clear Channel, and Huntsman Corporation. I have experience in all phases of capital raising and balance sheet restructurings, including out-of-court exchanges and debtor-in-possession (DIP) financings, and I am currently involved with a number of high-profile bankruptcy and restructuring matters.

I bring to bear extensive experience in leveraged finance, as well as knowledge of the bankruptcy process and current market dynamics, to guide clients through the DIP financing process. An in-depth knowledge of complex financing structures and issues is essential, as this expertise is as important for DIP financing as it is for non-bankruptcy financing. My ability to combine this expertise with knowledge of the substantive and procedural bankruptcy process (which is often unfamiliar to even senior bankers and executives) is key to effectively counseling clients on DIP financing.

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