Do Economic Conditions Drive DIP Loan Terms?[*]

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A firm that seeks refuge in Chapter 11 often requires financing for its continuing operations in bankruptcy. Its pre-bankruptcy sources of credit typically dry up, and it often cannot proceed without what is known as debtor-in-possession ("DIP") financing. To induce such lending, the Bankruptcy Code authorizes the debtor to provide prospective lenders with sweeteners that make DIP financing more attractive. But because these inducements are thought to come at the expense of other stakeholders, the Code requires the debtor to convince the court that no less generous a package would have been sufficient to obtain the loan.

In response to anecdotal evidence that DIP loans have become littered with these lending inducements in recent years, some have begun to question whether these sweeteners are truly necessary to induce lending, suggesting instead that DIP lenders now extract excessively generous terms (American Bankruptcy Institute 2014). In response, defenders of DIP lenders note a simple explanation for this seeming increase in inducements: reduced credit availability during the Financial Crisis (e.g., Barnett & Brian 2010). When credit is tight, of course lenders need more sweeteners—which is why judges have explicitly relied on credit-market conditions to justify their approval of "extraordinary" lending inducements.

In this Article, we examine whether credit availability explains the use of lending inducements in DIP loans. Using a hand-collected dataset including detailed information on DIP loan terms from 2004 to 2012, we provide the first evidence on the relationship between these terms and credit availability. We show that standard terms, like loan pricing and covenant structure, are indeed sensitive to economic conditions. But we also offer evidence that the extraordinary inducements found in DIP loans are unrelated to the broader economic conditions that have been cited to justify their approval.

We begin by examining two ordinary DIP contract provisions: loan price (interest rate and fees charged by the lender) and covenant structure. As to the latter, we focus primarily on reporting covenants, which govern the frequency with which the debtor must report specified financial information or events to the lender.[1] Our evidence indicates that these terms have clear relationships with broader economic conditions.

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[*] Excerpted from Colleen Honigsberg & Frederick Tung, *Do Economic Conditions Drive DIP Lending?: Evidence from the Financial Crisis*, https://ssrn.com/abstract=2828295.

[1] A reporting covenant may, for example, require the borrower's monthly reporting of its cash flows. E.g., Debtor-in-Possession Credit Agreement, dated as of January [ ], 2012, among Eastman Kodak Company and Kodak Canada Inc., as Borrowers, The U.S. Subsidiaries of Eastman Kodak Company Party Hereto, as U.S. Subsidiary Guarantors, and The Subsidiaries of Kodak Canada Inc. Party Hereto, and the Lenders Named Herein, as Lenders, and Citicorp North America, Inc., as Agent and Collateral Agent, and Citicorp North America, Inc., as Syndication Agent, and Citigroup Global Markets Inc., as Sole Lead Arranger and Bookrunner, at 79.

We then turn to two "extraordinary" lending inducements that some judges and lawyers have found troubling: "roll-ups" and case milestones (American Bankruptcy Institute 2014, 73-83). DIP financing is commonly provided by the debtor's major pre-bankruptcy secured lender, and roll-ups allow these DIP lenders to reduce their own financial risk by requiring the debtor to use the DIP loan to pay off some—or more typically all—of the DIP lender's secured pre-bankruptcy claim against the debtor. This gives the DIP lender a peace of mind rarely enjoyed by other creditors in bankruptcy.[2] Case milestones set specific deadlines for important events in the case, giving lenders critical control over the reorganization process and curbing the discretion of the debtor's management and the bankruptcy court.[3] For example, a common milestone sets a drop-dead date for the filing or court approval of the reorganization plan. A less common milestone sets a deadline for court approval or completion of a specified sale of debtor assets.[4] These provisions are controversial because too-tight deadlines may advantage senior creditors—like DIP lenders—at the expense of junior creditors.[5] Moreover, case milestones are not clearly authorized under the Bankruptcy Code—in some instances, they may even contradict specific provisions of the Code (United States Bankruptcy Court for the Southern District of New York 2002).[6]

Although these extraordinary provisions have been justified as a response to credit availability, our empirical analysis fails to identify a significant relationship between these variables. We would expect the use of lending inducements to move in the debtor's favor with increasing credit availability (and against the debtor with credit tightening). Indeed, we see this result in the "ordinary" provisions (i.e., pricing and loan covenants) that we examine. However, despite our use of multiple empirical measures for credit availability and extraordinary provisions, we see no evidence that the use of these lending inducements is related to economic conditions during our sample period.

Our paper has significant policy implications for bankruptcy participants. The market for DIP financing has grown steadily in size and significance in the last two decades as the size of public company bankruptcies has increased. Individual judges deciding whether to approve extraordinary provisions face a difficult decision. They must assess whether the extraordinary terms are necessary to induce lending, but they do not have the benefit of counterfactuals. Judges worry that, if the proposed DIP loan is the only one on offer—as debtors and their prospective DIP lenders typically profess—rejection of the DIP loan would spell doom for the debtor. These judges quite understandably hesitate to reject DIP loans under these circumstances, and instead

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[2] Moreover, the new DIP debt, including the roll-up (that is, the amount incurred to repay the DIP lender's pre-bankruptcy claim against the debtor) enjoys an especially high priority in payment in reorganization. Roll-ups are controversial because the Bankruptcy Code's enumeration of permissible DIP lending inducements does not include roll-ups, *see* 11 U.S.C. § 364; indeed, roll-ups are arguably inconsistent with the Code's priority scheme. *See, e.g.*, Part II.A.1.

[3] In a traditional Chapter 11 reorganization, the debtor and its multiple creditors negotiate over the financial (and sometimes operational) restructuring of the firm. The general goal is to reduce the debt burden on the company such that its operations can generate sufficient cash flow to service the remaining debt. Eventually a plan of reorganization memorializes this multiparty bargain; the plan requires both creditor consent and judicial approval, *see* 11 U.S.C. § 1129.

[4] *See infra* Part II.A.2.

[5] For example, a quick sale of debtor assets may generate sale proceeds sufficient only to pay off a senior creditor, while a longer marketing period might have helped realize a higher sale price. Lynn M. Lopucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV 106 (2007).

[6] *See, e.g.*, Guidelines for Financing Requests: United States Bankruptcy Court for the Southern District of New York, Int'l Insolvency Inst. at 8 (Mar. 20, 2002).

reluctantly approve the arrangements on the view that the terms were necessary to induce critical lending. At the policy level, recognizing the potentially problematic nature of extraordinary provisions, the American Bankruptcy Institute's recent Chapter 11 reform proposals offer guidelines to curb or delay the effects of such DIP provisions (American Bankruptcy Institute 2014, 79-83).

In this Article, we provide, to our knowledge, the first empirical evidence questioning the longstanding and widely held assumption that extraordinary provisions are a function of credit availability. We hope that our analysis will help policymakers, judges, and other bankruptcy participants to better evaluate the DIP lending process in order to optimize DIP loan structure going forward.