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A Slow Comeback for Chapter 11 Financing

Fat incentives lure some banks back to the market, but many, wary of regulatory scrutiny, remain on the sidelines.

By Joseph Rosta

When the financial markets shuddered last September following the failure of Lehman Brothers and the near-death experience of AIG, debtor-in-possession financing dried up and lay dormant for months-just as Chapter 11 filings were accelerating. Pressed beyond the edge, companies that under normal circumstances would have been thrown a financing lifeline allowing them to restructure, were forced to liquidate instead. Banks pulled backed back from the market as they focused on cleaning up their balance sheets.

By the middle of this year, however, the DIP market was showing signs of life, though mostly with pre-petition lenders - those already holding debt in the troubled companies - attracted by extraordinary terms. UBS, Citigroup, Goldman Sachs, and Deutsche Bank have returned in force. Private equity funds, too, are taking up some of the slack, mainly because more lucrative targets for their money have evaporated.

That's not to say the market is back to normal. Banks with no stake in a company facing Chapter 11 have been staying away-even those with their stress tests behind them. And many banks, big and small alike, remain on a hiatus, still concentrating on balance -sheet problems and wary of examiners' concerns about risk-weighted assets.

Before the financial market meltdown, DIP financing was robust, with an array of money center, regional, and some smaller banks lured by its high rates and fees. The loans must be repaid before existing debt, equity and other claims. Very few of the unsecured DIPs prior to the current recession went sour, according to Alan Zimmerman, who covers DIP loans for Standard & Poor's Leveraged Commentary and Data group.

William Sheehan, a banking partner with law firm Simpson Thacher & Bartlett, which advised UBS Securities in the $8 billion DIP financing for Lyondell Chemical Co. earlier this year, says that distressed companies have to offer better rates and terms than they have in the past. "DIP deals are getting done - we're working on one after another - but it's an expensive market, and it's difficult to entice lenders," he says.

The Lyondell deal is a case in point. The participants were all pre-petition lenders, Sheehan notes. Just days after Lyondell filed for Chapter 11 protection the lenders extended the firm $2.17 billion in financing in exchange for a term sheet and promissory notes. And the final agreement included a $3.25 billion roll-up of part of Lyondell's pre-petition senior debt, assuring full repayment at the end of the process, ahead of other creditors.

But there's a limit to how creative DIP deals can get. They require court approval, and other creditors can blow up a DIP with competing offers. In the Lyondell case the judge agreed that the roll-up DIP was the best that the company could do, considering the dire economic conditions it faced. He cautioned, though, that his decision could not be used as a precedent. Since then, such roll-ups have become common in DIP financing, reflecting the thinness of the market, observers say.

David DiPiero, the president and CEO of FGI Finance, adds that there are fewer players in the DIP market because the industry is consolidating. Bank of America's acquisition of Merrill Lynch, for example, eliminated an active DIP lender. With fewer lenders, "companies in need are going to have trouble," he says. "But I think you'll see capital coming in from outside traditional sources."

In lieu of traditional DIP financing, distressed companies and their creditors are also turning to other sources. Lenders are approving amended agreements providing covenant relief, prearranged deals to postpone Chapter 11 filings by as much as two years on the expectation that the economy will improve to the extent that the troubled company might regain its health, or that the DIP market would return to normal.

Some are convinced that DIP lending is about to rebound, seeing fewer roll-ups and strong investor appetite. "Some of the interest is in the form of bank business," notes the head of the leverage group at a major bank. "Now that they're comfortable passing their stress tests and confident they can syndicate loans, some banks are committing," he says.

Still, many institutions remain wary, fearful of crossing regulators. "On the one hand, regulators are saying be careful of your risk-weighted assets," says one banker. "On the other hand, I would imagine President Obama would want banks to support reorganizations and preserve jobs."