KEY POINTS

- In the current credit market, loans to chapter 11 debtors are more difficult to obtain, and come with more restrictive terms, interest and fees.
- Debtors must increasingly rely on existing creditors to extend additional financing, as fewer traditional lending institutions are willing to lend to troubled corporations.
- Despite the credit crunch, lenders and debtors are negotiating innovative loan packages, including the record $8.25bn debtor-in-possession ('DIP') loan recently made to LyondellBasell Industries.

Feature

Authors John J Rapisardi and George A Davis

Lyondell: the largest commercial DIP in history

Despite the downturn in the economy, certain entities in bankruptcy in the US are able to obtain substantial financing on innovative terms.

Chapter 11 of the US Bankruptcy Code is intended to facilitate corporate reorganisation, rather than liquidation, which is often the fate of corporations placed in insolvency proceedings elsewhere around the world. Attempting to reorganise, however, requires liquidity, which bankrupt companies lack by definition. Often one of the first things a company must do after commencing bankruptcy proceedings in the US is to obtain court approval for a loan, called debtor-in-possession, or 'DIP', financing. These loans are considered obligations of the debtor's chapter 11 estate, and have priority over all pre-bankruptcy obligations including, in some cases, super-priority over the debtor's pre-bankruptcy secured lenders. The recent example of the successful DIP loan approved in the LyondellBasell Industries bankruptcy case is a case in point of the evolving DIP credit market.

DIP DEMAND

Because DIP loans are the first obligations a company must pay when it emerges from bankruptcy, they have traditionally been considered extremely safe for lenders and have been readily obtained by debtors in chapter 11. The worldwide contraction of the credit markets, combined with increased default rates on corporate loans, has resulted in increased demand for DIP financing and few lenders available to make such loans.

The last year has seen JPMorgan Chase Bank purchase Bear Stearns, Barclays acquire the Lehman Brothers broker-dealer business, and Bank of America absorb Merrill Lynch. Although the private equity and hedge fund sector has lent into the DIP market, such alternative lenders have been reluctant to extend new funds in the current cycle. In addition, companies facing bankruptcy are often over-leveraged, with few assets unencumbered by pre-bankruptcy liens to tempt banks to offer new credit. The result is that insolvent companies most often seek financing from their existing lenders, and have little leverage to negotiate flexible terms.

If an insolvent company is unable to obtain DIP financing, its only options are to liquidate or to try to restructure without formally commencing chapter 11 proceedings. Neither option benefits the bankrupt company's existing lenders, who as a rule of thumb will recover less on their loans if a company liquidates than if it successfully reorganises. As a result, the existing lenders have an incentive to provide DIP financing – they extend additional funds in order to protect their existing claims. Even if they are unwilling to meet a debtor's total long-term liquidity needs, existing lenders are sometimes prepared to lend sufficient funds to keep the company afloat until it can be sold as a going concern pursuant to s 363 of the US Bankruptcy Code. However, due to the global economic downturn and inability of prospective purchasers to secure financing in today's lacklustre US financing market, even this tried and true practice has not been a viable secured lender strategy in recent restructurings.

Even existing lenders, however, are often not positioned the way they were in previous economic downturns. The expansion of the debt, or claims, trading market means that the parties holding debt when a company enters bankruptcy are often not the same parties who initially extended the credit. These debt holders take their positions late in the game, and may have incentives beyond merely maximising recovery on their claims, some using their claims as a 'fulcrum' security to convert their debt into ownership of the reorganised company upon its emergence from bankruptcy. The presence of these new players may also impact negotiations for DIP financing. If a DIP loan 'primes' pre-bankruptcy debt, the claims of these holders may be devalued in the claims trading market. If those lenders participate in the DIP financing, however, they may be able to negotiate DIP loan terms that result in a greater recovery on their claims.

LYONDELLBASELL INDUSTRIES' CHAPTER 11 FILING

LyondellBasell Industries ('Lyondell'), one of the world's leading oil refiners and polymers and petrochemical producers, filed its US subsidiaries and one of its European holding companies for bankruptcy on 6 January 2009. As of the filing, Lyondell estimated total assets of $27.1bn and debts of approximately $19.3bn. In the initial papers filed with the court, Lyondell requested approval of an $8.25bn DIP financing package, almost twice as much money as had ever been granted to a bankrupt corporation. The court granted Lyondell emergency access to $100m and then approved $2bn of the loan on an interim basis two days later.

The Lyondell DIP was not obtained without a fight. Parties negotiated around the clock through the Christmas and New Year's holidays before Lyondell's bankruptcy filing. The court hearing addressing initial approval of the financing lasted well over eight hours, and the hearing on final approval stretched over three days at the end of February. The bankruptcy court granted final approval for the Lyondell DIP on 1 March, as of which time it was one of the largest DIPs in history. Rather

Feature

Biog box
John J Rapisardi and George A Davis are partners in the financial restructuring department of Cadwalader, Wickersham & Taft LLP. Email: john.rapisardi@cwt.com and george.davis@cwt.com
Meghan Sercombe, an associate of the firm, assisted in the preparation of this article.

than demonstrating an improvement in the lending market, the Lyondell DIP terms reflect the pricing and incentives borrowers must agree to for lenders to participate. Judge Robert Gerber approved the loan despite expressing concerns about certain terms, acknowledging that it was the only funding available to the company in 'these terrible economic times'.

Fourteen lenders participated in the Lyondell DIP loan, contributing a total of $3.25bn in new money. The DIP financing is made up of two components: a $6.5bn term loan facility, led by UBS and comprised of $3.25bn in new money and $3.25bn in 'rolled-up' pre-bankruptcy debt, and a $1.54bn asset-backed lending facility on which Citigroup is lead bank.

LYONDELL DIP TERMS

Whether a bankrupt company is seeking financing from an outside lender or an entity that has previously extended financing, to secure such loans, they are increasingly required to accede to terms that may be considered onerous or certain to force the bankrupt company into default. Aside from its size, which is in itself significant, several key features of the Lyondell DIP are worthy of notice and are illustrative of the current DIP market.

MATURITY DATE AND MILESTONES

One highly contested feature of recent DIP financing agreements is their duration. Many of the loans, including Lyondell's, mature within a year or less and may only be extended in extremely limited circumstances. Certain of Lyondell's pre-petition creditors argued that the repayment deadlines were unreasonable and were certain to push the company into default, as it is unrealistic to confirm a plan of reorganisation in such a short timeframe.

The Lyondell loan matures in December 2009. The loan documents allow the deadline to be extended, provided any new money lenders who do not consent are replaced and paid all required exit fees. In addition, the loan facility includes significant milestones tied to the December maturity date. Specifically, Lyondell must deliver a draft reorganisation plan by mid-August, file the plan by mid-September, and have the plan confirmed by December.

While the bankruptcy court in Lyondell expressed serious concern about these deadlines, the lenders persuasively argued that they could not accurately forecast market conditions for a longer time period, and that they either needed repayment before year-end or the ability to renegotiate their commitments at that time.

INTEREST RATES AND LOAN FEES

There may be a larger market for DIP financing, as more companies file for chapter 11, but there is also a higher cost of capital. The Lyondell DIP loan is priced at an approximately 13 per cent interest rate plus an additional 7 per cent in commitment and exit fees. Although expensive, these costs are comparable to those provided in other recent DIPs and are obviously better than the alternative – liquidation. For example, VeraSun Energy Corp obtained an approximately $196m DIP loan priced at an interest rate of 16.5 per cent plus an additional 4 to 7 per cent in commitment and exit fees.

In addition to higher interest rates, DIP lenders are also escalating fees. The 3.5 per cent fee Lyondell agreed to pay its lenders is typical of recent DIP loans. For example, bankrupt Tronox disclosed that its lead arranger, Credit Suisse Group AG, will be paid a 3 per cent fee in addition to a $175,000 up-front fee and a $175,000 annual fee, and the Lenox Group DIP loan provides for a 4.5 per cent fee.

THE ROLL-UP

The most innovative feature of the Lyondell DIP was its partial 'roll-up' of pre-bankruptcy debt, which effectively converted the lenders' pre-bankruptcy debt into a post-bankruptcy obligation of the company. Roll-ups are effected either by advancing money pursuant to a DIP facility or by deeming the monies to have been advanced and applied to the pre-bankruptcy debt. Roll-ups create the possibility that a pre-bankruptcy lender will improve its position relative to other creditors or the debtor, and bankruptcy courts have typically been reluctant to approve such provisions absent a showing that the benefits to the debtor outweigh the potential harm to the disadvantaged creditors. In the current credit market, in which a company may be forced to liquidate without the offered financing, this test is often easily satisfied and, increasingly, DIP loans include roll-up provisions.

Traditional roll-ups have involved asset-backed revolvers. The creative twist to the Lyondell loan was that it involved the roll-up of secured term loans and provided that the rolled-up debt could be satisfied under a plan of reorganisation with a five-year secured note with an interest rate to be agreed or, failing that, determined by the bankruptcy court to provide the roll-up lenders with a present value as of the effective date of the plan equal to the amount of their rolled-up debt. This was an important component of the DIP for the debtors to ensure that they would be able to emerge from chapter 11 even if they could not refinance the rolled-up debt at the time of emergence. Rolled-up debt is considered an administrative claim against the bankrupt company's estate, and the US Bankruptcy Code provides that it must be paid in full in cash for a plan of reorganisation to be confirmed. The Lyondell DIP avoids this pitfall and provides that the roll-up loans do not have to be paid in cash on their maturity date.

CONCLUSION

Certain Lyondell creditors contested the terms of the DIP financing, arguing that it imposed unrealistic deadlines certain to force the company to default, and that it did not adequately protect the interests of the creditors who had been primed by the new loan. Others argued that they should have been allowed to participate, or were entitled to the same benefits afforded to the new money lenders. None of these objections trumped the fact that the terms offered were the only ones available to the company, and that without financing, Lyondell would have been forced to liquidate. The Lyondell DIP demonstrates that financing can be obtained in the current credit market if bankrupt companies and their existing creditors make necessary concessions, and that parties continue to search for creative solutions to funding needs. ■