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Freefalling With A Parachute That May Not Open: Debtor-In-Possession Financing in the Wake of the Great Recession

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I. INTRODUCTION

The premise of Chapter 11 bankruptcy is that companies are often more valuable to creditors and the economy as a whole as ongoing businesses, rather than storehouses of assets waiting for liquidation. Debtor-in-Possession (DIP) financing is a critical part in the successful reorganization of a company in Chapter 11.[1] DIP lending is a way for debtors to obtain post-petition loans to help them effectively emerge from Chapter 11 bankruptcy.[2]

However, the economic downturn, referred to by some as the "Great Recession,"[3] has caused a freeze in the credit markets. While the current economic malaise has caused an expected increase in bankruptcies, the credit "freeze" that accompanied the downturn has made the need for DIP lending more critical. The usual lenders of DIP financing have exited the market, presumably due to either a lack of liquidity or their own financial struggles. Without DIP loans to maintain business operations during bankruptcy, companies may be forced to liquidate rather than reorganize under Chapter 11. In order to stop the "Great Recession" from worsening, alternative sources of DIP lenders must emerge to help fill the new void.

The alternative DIP lenders may come from a variety of sources. Smaller regional banks may be able to step in and fill some of the demand for DIP loans by either lending directly to the smaller companies or becoming part of a group that lends to larger companies. Meanwhile, equity and hedge funds possess some of the capital and liquidity to meet the demand for larger DIP loans. Should either of these two sources fall short of market demand, the government may need to inter-

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1. David A. Skeel, Jr., *The Past, Present and Future of Debtor-In-Possession Financing*, 25 CARDOZO L. REV. 1905, 1906 (2004).

2. The current DIP financing statute can be found at 11 U.S.C. § 364 (2006).

3. *See, e.g.*, Matthew Benjamin, *Volcker Says U.S., World in "Great Recession,"* BLOOMBERG.COM, Apr. 23, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=ALgZJsnlVtPI&refer=home.

vene. The government could assist by either directly lending to corporations or establishing an agency to guarantee the repayment of the DIP loans. None of the aforementioned resources are mutually exclusive. In fact, it is quite possible that the current financial climate may need some or all of these resources to meet the demand for DIP loans.

Part I of this note is an introduction briefly discussing the history and current state of DIP financing. Part II discusses how regional and community banks now have the opportunity to partially fill the vacuum in DIP financing left by the larger banks. Part III explores the options available to hedge funds and private equity funds as they investigate and enter the DIP financing market. Next, Part IV discusses the government as the DIP financer of last resort, with General Motors serving as a reference. Additionally, that part explores the practicality of a government DIP lending agency, which could insure certain DIP loans. Finally, Part V discusses the risks associated with the new DIP lending market, exploring both inflation and the increased risk of default on DIP loans. Part VI concludes the note.

A. *A Brief History of Debtor-in-Possession Financing*

Chapter 11's post-petition financing guidelines originate from the large-scale corporate reorganizations of the early 1900's. Beginning with what were called common law "equity receiverships," they assisted in the reorganization of America's distressed railroads.[4] Courts even promised special repayment priority to lenders assisting the reorganization financing.

A receiver's certificate was a promissory note "by which the railroad borrowed from the investors against the credit of the 'whole estate' of the railroad."[5] Like modern-day DIP loans, the certificates took priority over all other railroad debt obligations.[6] These certificates also had a very high probability of being repaid.[7] "Receiver's certificate" loans helped railroads stay in business during the restructuring process, much like a DIP loan does today.[8] A number of non-railroads eventually began to use this receivership process to restructure, slowly leading to the current DIP process.[9]

DIP financing, however, has only recently taken the center stage.

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4. For an interesting discussion on the origination of large scale corporate reorganization in America, see DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 48–69 (2001).

5. Skeel, *supra* note 1, at 1912.

6. *See id.* at 1911.

7. *Id.*

8. *Id.* at 1905.

9. *Id.* at 1912.

The role of the financers has changed—from bankers to powerbrokers. Indeed, DIP lenders have wielded significant power in the recent past. For example, the bank responsible for the DIP financing after the United Airlines bankruptcy obtained large wage concessions from the unions.[10]

B. *Current State of Debtor-in-Possession Financing*

DIP financing used to be a relatively profitable, low-risk commitment of funds because DIP lenders are among the first to be repaid.[11] The loans also generally mature within two years, minimizing the long-term risk of default.[12] For example, "[m]ost professionals can recall only one big DIP loan, to Winstar Communications, that was not paid back."[13] This history buttresses the claim of University of Texas law professor Jay L. Westbrook that "[u]sually a lot of companies compete to make debtor-in-possession loans."[14] In fact, prior to 2008, obtaining DIP lending was considered one of the easier aspects of Chapter 11 reorganization.[15]

The recent sizeable shift in the U.S. financial landscape, however, has changed DIP financing.[16] The current downturn has changed many historical assumptions of the business world. For instance, large-scale bank failures were generally assumed to be a relic of the 1920s and 1930s and relegated to textbook footnotes. Yet, the struggling economy and instability in the financial markets that caused these failures created a situation in which the credit market apparently dried up overnight in the second half of 2008.[17] The general reluctance of banks to lend, fueled by uncertainty over balance sheets and bad loans, caused banks to seek other opportunities.[18] Because businesses can buy up old loans to companies with good financial profiles, the incentive to lend money to

10. *Id.* at 1906; Marilyn Adams, *Low-Cost Carriers Plan Trips Up UAL*, USA TODAY, Mar. 14, 2003, at 3B.

11. 11 U.S.C. §§ 364(c), 1129(a)(9) (2006).

12. Michael J. de la Merced, *Auto Bailout Pricey? Try Bankruptcy—GM Says Financing Would Cost $100 Billion, but Many Doubt It*, INT'L HERALD TRIB., Feb. 20, 2009, at F12.

13. *Id.*

14. Ben Levisohn, *Fewer Lifelines for the Bankrupt*, BUS.WK., Jan. 19, 2009, at 22.

15. *Double DIP: Bankruptcy Loans Scarce and Scary Expensive*, FIN. WK., Jan. 19, 2009, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090119/REG/901139993/-1/FW IssueAlert01.

16. Levisohn, *supra* note 14.

17. Ben S. Bernanke, Chairman, Bd. of Governors of the U.S. Fed. Reserve Sys., Address at the Economic Club of New York, New York (Oct. 15, 2008) [hereinafter Bernanke, Club of New York], *available at* http://www.bis.org/review/r081016a.pdf; Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the Stamp Lecture, London School of Economics (Jan. 13, 2009), *available at* http://www.lse.ac.uk/collections/LSEPublicLecturesAndEvents/pdf/20090113_Bernanke.pdf.

18. Levisohn, *supra* note 14.

cash-strapped borrowers has decreased because the risk of lending has increased.[19] Moreover, because some companies "gorged themselves" on cheap credit in better economic conditions, they now have limited collateral to pledge as security for any DIP financing that may appear.[20] As one credit analyst put it, "Why would you lend to an insolvent company when you can invest in other [debt] products with [similar] risk and higher returns?"[21]

While the government wants to stabilize financial markets and stimulate bank lending through various programs like the Troubled Asset Relief Program (TARP)[22] and Public-Private Investment Fund (PPIF),[23] companies on the verge of bankruptcy still face an uncertain future.[24] DIP lending has generally become scarce and quite expensive once found.[25] The lack of DIP lending caused some companies to delay Chapter 11 filing.[26] Other companies that file for protection could be forced to liquidate due to the lack of cash to continue operations during their bankruptcies.[27]

There are, however, still several players committed to the DIP financing market.[28] In fact, General Electric Capital (GE), historically one of the largest providers of DIP lending, "plans to hand out approximately $2 billion in debtor-in-possession loans this year, up from the $1.9 billion it awarded companies restructuring under Chapter 11 protection last year."[29] GE's willingness to increase funding for DIP lending, however, likely cannot meet the increased demand for loans because

19. *Id.*

20. Merced, *supra* note 12.

21. Levisohn, *supra* note 14.

22. *See* Bernanke, Club of New York, *supra* note 17.

23. Timothy Geithner, *My Plan for Bad Bank Assets*, WALL ST. J., Mar. 23, 2009, at A15.

24. Bernanke, Club of New York, *supra* note 17.

25. *See, e.g.*, Emily Chasan & Caroline Humer, *Bankruptcy Financing Seen More Costly as Wave Hits*, REUTERS.COM, Jan. 13, 2009, http://www.reuters.com/article/newsOne/idUSTRE50B7KJ20090113; Chelsea Emery, *Packaging, Trucking Companies Could Struggle in 2009*, REUTERS.COM, Jan. 6, 2009, http://www.reuters.com/article/ousiv/idUSTRE50603E20090107.

26. *Tight Bankruptcy Financing to Hurt Bondholders-Report*, REUTERS.COM, Nov. 10, 2008, http://www.reuters.com/article/rbssAutoTruckMotorcycleParts/idUSN1047135620081110.

27. Jeffery McCracken & Paul Glader, *'DIP' Loans Are Scarce, Complicating Bankruptcies*, WALL ST. J., Oct. 17, 2008, at C1. According to Howard Davidowitz, chairman of the New York based national retail consulting firm Davidowitz & Associates, "The kind of debtor-in-possession financing that's available . . . is the type that lends you money for a short period until you liquidate." Joan Verdon, *Chapter 11 for Hip-Hop Retail Chain—Against All Odds Cites Crunch*, N.J. RECORD, Jan. 7, 2009, at B01. The ironically named retailer plans to use the DIP loan to pay off creditors, then close stores on the West Coast and "either reorganize or sell its East-Coast locations." *Id.*

28. As one small example, "JPMorgan Chase, for example, is actively involved in the market. . . . GE Capital says it is too." Merced, *supra* note 12. Bank of America also has a heavy presence in the current DIP lending arena. Levisohn, *supra* note 14.

29. *GM Bondholders Hold Out For More*, BANK LOAN REP., Feb. 23, 2009, at 3.

"the number of bankruptcies [should] climb by a much higher rate than five percent, the increase to the amount the firm has set aside for [DIP lending]."[30] GE will also charge higher rates for the DIP loans it does make, which will inevitably price some borrowers out of the market.[31] Many lenders are likely to play follow-the-leader when it comes to pricing loans.[32]

II. Regional and Community Banks as a New Source of DIP Lending

Quite logically, the largest providers of pre-recession DIP financing were the large financial institutions. The acquisition of a massive market share by these lenders comes from their corporate expansions.[33] As a historical comparison, "In 1985, there were 14,000 community banks with inflation-adjusted assets of less than one billion dollars. Today, their number is smaller by half. Many communities, especially those in urban America, have lost most or all of their local banks."[34] The large fund reserves and national prominence put big institutions at the top of the lending market.[35] The changing economy and its corresponding damage to many large lenders, however, will limit these lenders' abilities to be the main source of funding for the immediate future.[36]

A. *Reasons Why Regional and Community Banks Would Provide DIP Financing*

The current crisis has generated a tidal wave of distrust in the bank-

30. *Id.*

31. *Id.* ("GE will charge between three percent and five percent for financing these loans. Over the past several years it has charged roughly two percent.").

32. *Id.* ("Borrowing for bankrupt companies in general has gotten more expensive, according to Standard & Poor's. The cost of a DIP loan in 2008 was roughly 400 to 750 basis points over Libor. That is up from a range of 225 to 600 basis points over Libor in 2007.").

33. Phillip Longman & T.A. Frank, *Too Small To Fail*, WASH. MONTHLY, Nov. 1, 2008, at 14.

34. *Id.*

35. *Id.* Indeed,

> [f]or decades now, most experts have argued that in finance, bigger is better. With their economies of scale, larger institutions are more efficient, goes the reasoning. They can match up lenders and borrowers all about the globe, tapping into places where money is piling up (like China or the United Arab Emirates) and directing those funds to borrowers in places where money is scarce (like Stockton, California, or East Cleveland, Ohio).

Id.

36. As one New York newspaper explained, "With Citigroup and Wells Fargo battling for Wachovia, and big buyouts by JP Morgan Chase of Washington Mutual and Bank of America of financial giant Merrill Lynch, the landscape is changing fast." Elizabeth Lazarowitz, *Amid Financial Crisis, Healthy Community Banks See Opportunity To Grab New Customers*, N.Y. DAILY NEWS, Oct. 3, 2008, at 3.

ing industry as a whole.[37] First, bank executives do not trust their counterparts at other institutions because they simply cannot tell what debt is good,[38] even in the context of a merger.[39] This lack of trust could prevent large lenders not only from working with one another, but taking on some loans made by other lenders. More damaging, however, is the lack of consumer confidence in banks.[40] If customers do not believe that a bank is capable of weathering the current storm, they are unlikely to pledge their property as security to a lender that may fail through no fault of their own.[41]

New opportunities, however, often emerge from the ashes of their predecessors—"[w]hen one door closes, another opens; but we often look so long and so regretfully upon the closed door that we do not see the one which has opened for us."[42] The inability of large banks to fulfill the need for DIP financing could set the stage for regional and community banks to enter the market and provide much-needed funds for reorganizing enterprises. Regional banks have generally not been exposed to

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37. Longman & Frank, *supra* note 33. Much of this stems from the large bank involvement in secondary markets: "When the going still seemed good . . . big banks took on more and more debt to stay competitive. By the end, Lehman Brothers was borrowing forty-five dollars for every dollar of its own that it was lending." *Id.*

38. *See* Sarah van Gelder, *The Banks Don't Trust Each Other, So Why Should We?*, HUFFINGTON POST, Dec. 9, 2008, http://www.huffingtonpost.com/sarah-van-gelder/the-banks-dont-trust-each_b_149495.html (noting that banks no longer trust each other because of bad debt).

39. Longman & Frank, *supra* note 33 ("While massive mergers give big banks more market share, they also create problems: the challenge of merging operations and even more bad loans on their books.").

40. *Citi, TARP and Trust: Banks May Trust Each Other More, but Consumers Lag Behind*, SEEKING ALPHA, Feb. 3, 2009, http://seekingalpha.com/article/118215-citi-tarp-and-trust-banks-may-trust-each-other-more-but-consumers-lag-behind. Indeed, one financial analyst notes,

> the word on the street from the man on the street (latest Gallup polls) is that consumers are currently enrolled in a 12-step program and it may be premature to expect them to fall off the wagon anytime soon. Consumers are still too painfully aware of hitting rock-bottom, and not enough progress has been made or enough time has passed to induce a false sense of self-control over their addiction to credit. Yesterday's Personal Income and Outlays economic report shows that consumers are holding on to their precious dollars. December 2008 spending declined for its sixth consecutive month, falling -1% after the previous month's -0.8% reading. Faced with shrinking income and the prospects of rising unemployment trends, borrowing money without certainty of the means to repay it may curb the cravings for more debt.

Id.

41. "[W]orries about which bank will be the next to fall may prompt customers to spread their money across multiple banks, benefiting some tiny ones, said Don Musso, president of financial consulting firm FinPro. 'The days of one-stop financial shopping are probably over.'" Lazarowitz, *supra* note 36. The customer loss from lack of faith is in addition to other issues that arise from big bank mergers, such as the change of financial products at the new institution and inevitable glitches from combining two entities. *Id.*

42. Alexander Graham Bell Quotes, http://www.brainyquote.com/quotes/authors/a/alexander_graham_bell.html (last visited May 24, 2009).

the huge financial losses that have crippled may larger institutions. Their smaller size limited their ability to enter the mortgage-backed securities market, and consequently bear the brunt of that market's collapse.[43] This limited exposure means that smaller lenders are in an excellent position to make loans.[44] The size of these banks means that some DIP loans are too large for them to make, but perhaps joint ventures between groups of banks can help bridge some of this gap. This possibility is realistic because smaller banks had less exposure to market loss, and their leaders may trust one another's balance sheets. If executives trust one another, they should be more likely to work together on lending commitments. Additionally, smaller banks generally have better relations with the members of their communities, which could mitigate the general lack of trust of financial institutions.[45] Given that smaller banks seem perfectly positioned to take advantage of the weaknesses of bigger lenders, they are a good option for prospective debtors in search of funding.

B. *Reasons Why Regional and Community Banks Would Not Provide DIP Financing*

To be sure, smaller banks will not prove to be a panacea for every debtor. There are several problems preventing regional and community banks from completely filling the need for DIP financing. First, smaller lenders have taken federal funds—notably from TARP—and may take a public image beating as a result.[46] This public image problem could hurt smaller banks tremendously, even though taking TARP funds is not equivalent to a death rattle.[47] Additionally, other bank leaders could see taking TARP funds as a sign of bad loans on the books. These confi-

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43.
> According to FDIC data, the failure rate among big banks (those with assets of $1 billion or more) is seven-times greater than among small banks. Moreover, banks with less than $1 billion in assets—what are typically called community banks—are outperforming larger banks on most key measures, such as return on assets, charge-offs for bad loans, and net profit margin.

Longman & Frank, *supra* note 33. Some lenders, however, made the business decision not to get carried away making loans that "[d]idn't make sense" because "we said, 'We don't do everything. We have standards.'" Jim Kavanagh, *Personal Touch Helps Keep Banks Healthy*, CNN.COM, Oct. 17, 2008, http://www.cnn.com/2008/US/10/17/small.banks/index.html.

44. "The big banks are going to be very distracted . . . . The small banks with clean loan portfolios and adequate capital are going to take advantage of this." Lazarowitz, *supra* note 36.

45. *See* Kavanagh, *supra* note 43 (describing customer service as a hallmark of community banking practices, and that many customers bring business to these banks because of it).

46. David Milstead, *Healthy Banks Take Injection: Three in Colorado Tap TARP as an "Insurance Policy,"* ROCKY MOUNTAIN NEWS, Feb. 20, 2009, at 3.

47. "In fact, the emerging pattern with federal TARP—Troubled Asset Relief Program—money is that it's the healthiest banks who are getting the funds, while more troubled institutions may be deemed ineligible." *Id.*

dence issues could prevent small banks from taking advantage of their opportunities, particularly if the DIP loan involves a joint venture.

Another likely scenario is that debtors will simply need more cash than these banks can provide, forcing them to turn to larger lenders.[48] Large bankruptcies, such as Lyondell, simply require more money than any smaller lender can realistically make available. Combined with confidence concerns, this factor could hinder the power of many small lenders to participate in the large-scale DIP loans that current debtors need. Finally, the higher default rates on the collateral that forms the basis for the security of regional and community bank loans, like homes and cars, could present a sizeable problem.[49] These defaults mean that smaller banks will have less liquidity and thus further limit their ability to lend money to all debtors.[50] If they are to play any role in fixing the DIP lending problem, smaller banks have the most potential to help by funding projects that do not require large DIP financing. This role would allow larger players to use their available funds to help close the bigger holes in the current financing scheme.

III. The Role of Hedge Funds and Private Equity in DIP Lending

While some smaller banks can provide financing to small and midsized business, the need clearly remains for the presence of larger DIP lenders. With some of the world's largest banks struggling to survive in the current fiscal climate, the usual go-to lenders are unable to provide DIP financing in Chapter 11 cases.[51] In this environment, hedge funds

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48. In the years to come, giants like Citigroup, JPMorgan Chase, and Bank of America may emerge even bigger and stronger, leaving small banks facing more formidable foes than before, analysts said. Their bulk and broad reach will let them offer more services, faster and for less, squeezing out some competition. . . . "With their sheer size alone, they have a pricing advantage that none of the community banks can come up against . . . . They can bring a market to their knees [sic]."

Lazarowitz, *supra* note 36.

49. For lenders, there is little recourse when a home-equity loan defaults or a homeowner declares bankruptcy. They can seize the collateral for the loan, in this case the house, only after the primary mortgage is paid off. . . . Smaller banks have even more exposure to such loans. Overwhelmingly, the institutions that hold the most home-equity loans are regional banks . . . . Late payments and defaults in every other major category of consumer debt also rose in the first quarter, the American Bankers Association reported. Auto loans issued through car dealers have a delinquency rate of 3.13%, the highest since at least 1990, according the ABA. . . . Because [smaller banks] have fewer options than big Wall Street firms for raising emergency funds, these regional and local banks tend to be more vulnerable in a crisis.

David Cho, *New Crisis Threatens Healthy Banks*, WASH. POST, Jun. 22, 2008, at A1.

50. *Id.*

51. *See* McCracken & Glader, *supra* note 27.

and private-equity firms could provide additional sources of DIP lending.

A. *Reasons Why Hedge Funds and Private Equity Firms Would Provide DIP Financing*

1. LEGAL PROTECTIONS AFFORDED TO DIP LENDERS

The Bankruptcy Code provides DIP lenders several great protections. First, bankruptcy courts may give DIP lenders a super-priority lien on all of the debtor's unsecured assets.[52] If these super-priority liens fail to attract DIP lenders, the court may grant a priming lien and place DIP lenders in front of the secured creditors.[53] Additionally, debtors must pay DIP loans in full by the effective date of the plan.[54] Moody's reports that, as a result of these protections, only one of the 297 DIP facilities made to large, publicly traded companies since 1988 was not fully repaid.[55] The legal protections, combined with twenty years of historical data, suggest DIP loans can be low risk investments for hedge funds and private-equity firms. Hedge funds and private-equity investors are wary of the current economic environment and its risks. As a result, these groups may embrace the legal protections and low-risk investment opportunities of DIP loans.

2. PRICING AND TERM

While many traditional DIP lenders have become more hesitant to provide DIP financing, the need for DIP financing has increased as a result of the recession.[56] Consequently, DIP loans have drastically increased in price.[57] As recently as 2007, interest rates for DIP loans averaged LIBOR plus 250 basis points.[58] In the current environment, lenders charge as much as LIBOR plus 1000 basis points and up front fees of 3.5% of the total commitment amount, with an additional three-percent fee due when the debtor exits bankruptcy.[59] The maturity rates

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52. 11 U.S.C. § 364(c) (2006); Kelly Holman, *DIP Finance Providers Disappear*, IDDMAGAZINE.COM, Oct. 20, 2008, http://www.iddmagazine.com/issues/2008_41/186770-1.html?type=printer_friendly.

53. § 364(d). A priming lien is a lien that attaches in front of prepetition secured creditors as long as the court finds the prior creditors are adequately protected. *See id.*

54. § 1129(a)(9); Kelly Holman, *Roll-Ups DIP Their Toes*, IDDMAGAZINE.COM, Mar. 20, 2009, http://www.iddmagazine.com/issues/2009_12/-191347-1.html.

55. WILLIAM FAHY, MOODY'S COMMENTS ON DEBTOR-IN-POSSESSION LENDING 3–4 (2008).

56. *See* McCracken & Glader, *supra* note 27; *Double DIP: Bankruptcy Loans Scarce and Scary Expensive*, FIN. WEEK, Jan. 19, 2009, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20090119/REG/901139993/-1/FWIssueAlert01.

57. Chasan & Hurner, *supra* note 25.

58. McCracken & Glader, *supra* note 27.

59. Holman, *supra* note 54.

for DIP loans are decreasing as the costs increase. Previously, the average DIP loan matured between twelve and eighteen months after closing.[60] Now, the loan maturities are often six months or less.[61] This current pricing allows potential hedge fund and private-equity investors to receive significant returns in what has historically been a relatively low-risk investment without a long-term commitment of capital.

3. INVESTMENT OPPORTUNITY

Private equity and hedge funds may recognize DIP financing as an investment opportunity during the current economic downturn. While many traditional DIP lenders are struggling to manage their liquidity, fund managers possess the cash to participate in DIP lending.[62] Hedge funds manage an estimated one trillion dollars in assets,[63] while private equity funds raised $265 billion in 2008.[64]

In South Florida alone, fund managers have created several "opportunity funds" to capitalize on distressed real-estate investments.[65] These funds could both purchase a portion or all of a distressed company's debts and later become a DIP creditor.[66] As DIP creditors, these funds would have more control of the company's reorganization. Debtors also want to retain as much cash for operations after exiting bankruptcy, rather than repay all of their creditors in full. Therefore, debtors can offer their post-petition and pre-petition lenders equity in the newly restructured companies in exchange for reduced debt obligations.[67] Private equity and hedge funds can use these debtors' behavior to implement a "loan to own" strategy to gain control of a target company as a DIP lender.[68] Whether lending purely for the short-term return on a low-risk loan or as a strategy to gain equity in a target company, DIP financ-

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60. Holman, *supra* note 52.

61. *Id.*

62. Chasan & Hurner, *supra* note 25.

63. Svea Herbst-Bayliss, *Pensions Seen Fueling Hedge Fund Industry Growth*, REUTERS.COM, Mar. 26, 2009, http://www.reuters.com/article/PrivateEquityandHedgeFunds09/idUSTRE52O74N20090325.

64. Grant Thornton LLP, *Private Equity and Hedge Funds: New Players In The Game*, *in* AM. BANKR. INST.,CARIBBEAN INSOLVENCY SUMP. EDUC. MATERIALS 27 (2009).

65. AM. BANKR. INST. CARIBBEAN INSOLVENCY SUMP. EDUC. MATERIALS, *supra* note 64, at 8.

66. *See* Nancy A. Mitchell, *Nontraditional Lenders Face Corporate Governance Challenges*, TURNAROUND MGMT. ASS'N, Oct. 10, 2007, http://www.turnaround.org/Publications/Articles.aspx?objectID=8109.

67. *See* Holman, *supra* note 52 (referring to a proposed Tousa plan that converted $300 million of debt into equity).

68. Edith S. Hotchkiss et al., *Bankruptcy and the Resolution of Financial Distress*, *in* 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 235 (B. Espen Eckbo ed., 2008).

ing provides private equity and hedge funds additional investment opportunities in the current economic environment.

4. INVESTMENT PROTECTION AND CONTROL

Hedge funds and private-equity funds could use their role as DIP lenders to protect their investment in portfolio companies as well as maintain or attain additional control of the companies. Hedge funds and private-equity funds have already invested significant capital into the businesses in their portfolios. When their portfolio companies falter or enter bankruptcy, hedge fund and private-equity investments face significant risk. First, if the company cannot generate sufficient cash flow or secure DIP financing to continue its operations, the company could face liquidation. If the hedge funds or private-equity funds are unsecured creditors or equity shareholders, most, if not all, of their investments will be lost in liquidation.[69] Second, even if the portfolio companies can successfully reorganize, the "absolute priority rule" prohibits equity holders from receiving any value in the new company over an objecting creditor who is not fully repaid.[70] Therefore, hedge fund and private equity investors risk losing all of their investments in their bankrupt portfolio companies.[71] But by taking advantage of the legal protections for DIP lenders, the funds can improve their previous position both during and after a successful reorganization.[72]

B. *Reasons Why Private Equity and Hedge Funds Would Not Provide DIP Loans*

In addition to hurting banks, the "Great Recession" affects both private equity and hedge funds. Private equity and hedge funds watched their assets diminish in 2008 and 2009 as many of their investment companies defaulted on their debts.[73] With many of their investment companies teetering on the verge of bankruptcy or having already filed, the equity funds must decide if (1) the funds possess the capital to invest in the ailing companies, (2) the investment terms available to the funds make the investment worthwhile, (3) the companies have any long-term viability, and (4) alternatively, more profitable investments exist. Meanwhile, both private equity and hedge funds struggle to attract and retain

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69. *See* 11 U.S.C. § 507(a)(9) (2006).

70. *See* § 1129(b)(2)(B)(ii).

71. *See* Chelsea Emery, *"Premium" on Out-of-Court Restructuring in '09*, REUTERS.COM, Dec. 30, 2008, http://www.reuters.com/article/GCA-CreditCrisis/idUSTRE4BU00520081231.

72. Holman, *supra* note 54.

73. Andrew Ross Sorkin & Michael J. de la Merced, *Debt Linked to Buyouts Tightens the Economic Vise*, N.Y. TIMES, Nov. 3, 2008, at A1; *PE-Backed Bankruptcies*, DEAL.COM, May 11, 2009, http://www.thedeal.com/newsweekly/dealwatch/pebacked-bankruptcies.php.

investors.[74] Private equity fundraising in the first quarter of 2009 fell to the lowest level in six years.[75] Analysts also expect the hedge fund industry to shrink from over two trillion dollars in 2008 to about one trillion dollars by the end of 2009.[76] As a result, funds may choose to try to maintain their current assets rather than invest additional capital in DIP loans.

C. *the beginning of a trend?*

Two recent bankruptcies, Lyondell Chemicals and Aleris International, and Aladdin Capital's DIP fund illustrate the market's new acceptance of direct DIP lending.[77] In Lyondell, several private equity firms and hedge funds participated in one of the largest DIP facilities in history, eight billion dollars.[78] The Lyondell loan involved an estimated ninety percent of the DIP market's existing investor base.[79] This loan not only demonstrates the need for hedge funds and equity firms to participate in DIP lending during the current economic crisis, but it also shows the willingness of hedge funds and private equity to invest.

The Aleris International bankruptcy is an example of a private equity fund's attempt to protect its investment through DIP financing. TPG purchased Aleris through an affiliate for $1.7 billion in 2006, plus the assumption of $1.6 billion in debt.[80] After Aleris filed for bankruptcy in early 2009, TPG expressed interest in joining the one billion dollars DIP loan.[81] As of April 2009, however, TPG had not officially decided if it will participate. Industry observers believe that the Lyondell and Aleris cases may cause other equity firms to enter into DIP lending.[82]

In February 2009, Aladdin Capital, a fifteen billion dollars hedge

74. Kelly Holman, *PE Fundraising Declines to Six-Year Low*, IDDMAGAZINE.COM, Apr. 1, 2009, http://www.iddmagazine.com/news/-191749-1.html; Phil Wahba, *Hedge Fund Industry Still Feeling Madoff Effect*, REUTERS.COM, Mar. 27, 2009, http://www.reuters.com/article/PrivateEquityandHedgeFunds09/idUSN2544322520090326. For a more in-depth analysis of the perils of private equity funds, see Justin Browder, Note, *Private Equity Bust*, 63 U. MIAMI L. REV. * (forthcoming 2009).

75. Holman, *supra* note 74.

76. Herbst-Bayliss, *supra* note 63; Wahba, *supra* note 74. Analysts attribute some of this decline to the investors' reaction to the Bernard Madoff scandal, where he led a massive Ponzi scheme in which investors lost as much as sixty-five billion dollars. *See* Herbst-Bayliss, *supra* note 63.

77. *Aladdin Dips into DIP Market*, HEDGE FUND REV., Feb. 10, 2009, http://www.hedgefundsreview.com/public/showPage.html?page=839287.

78. Holman, *supra* note 54.

79. *Id.*

80. *TPG Interested in Aleris DIP Financing Source*, REUTERS.COM, Mar. 2, 2009, http://www.reuters.com/article/privateEquity/idUSN0243507620090302.

81. Holman, *supra* note 54; *TPG Interested in Aleris DIP Financing Source*, *supra* note 80.

82. Holman, *supra* note 54.

fund, announced the launch of a hedge fund to invest exclusively in the DIP market. According to the company, Aladdin's interest in DIP lending stems from the "tremendous opportunity to capture meaningful market share"[83] and to invest in low risk, high return investments appealing to pension funds and endowments,[84] which are the largest investors in the hedge fund market.[85]

The DIP structures in Lyondell and Aleris, along with the Aladdin fund, could be just the beginning of an increased role by hedge and equity funds in DIP financing. Whether the participation of hedge and equity funds as direct DIP lenders will continue is still uncertain. Government incentives or guarantees could encourage private equity and hedge funds to increase their participation.

IV. The Government and DIP Lending

The so-called "$64,000 question" when determining who is going to act as a DIP lender in the new financial landscape is straightforward: Who has the cash? While many hedge funds are sitting on large cash reserves,[86] the U.S. Government has more money than any hedge fund could ever hope to have.

A. *The United States Government as DIP Lender: Could It Work?*

General Motors (GM) is a broken company that is in dire financial straights.[87] The company came perilously close to insolvency in the fourth quarter of 2008, with only fourteen billion dollars in cash at the end of the quarter.[88] Only federal loans prevented a descent into insolvency.[89] GM continues to hemorrhage money at an alarming rate, with its cash cushion shrinking by billions of dollars each month.[90]

GM's problems extend beyond a mere shortfall in cash on hand. Labor costs are as much as fifty-percent higher than U.S.-based competitors.[91] Additionally, the company has substantial pension and healthcare

83. *Aladdin Launches Debtor-In-Possession Lending Hedge Fund*, FINALTERNATIVES.COM, Feb. 11, 2009, http://www.finalternatives.com/node/6911.

84. *Aladdin Dips into DIP Market*, *supra* note 77.

85. Herbst-Bayliss, *supra* note 63.

86. *See* discussion *supra* Part III.

87. *See* Bill Vlasic & Nick Bunkley, *G.M. To Cut 10,000 Salaried Workers*, N.Y. TIMES, Feb. 10, 2009, at B10.

88. Bill Vlasic, *G.M. Lays Its Future on Washington's Doorstep*, N.Y. TIMES, Feb. 26, 2009, at B1.

89. *Id.*

90. *Id.*

91. *See* Joshua Rauh & Luigi Zingales, Op-Ed., *A Bankruptcy To Save GM*, CHI. TRIB., Nov. 23, 2008, at C31. *But see* Tom Krisher, *Gap in Labor Costs Shrinks With New UAW Contract*, SAN DIEGO UNION-TRIB., Nov. 20, 2008, at 1 (noting that after GM cost cutting measures are

obligations that will be difficult to satisfy, amounting to liabilities that are higher than fifty percent of the book value of its total net assets.[92] GM has asked, and may continue to ask, for government loans.[93]

As GM loses money by attempting to retool itself outside of bankruptcy, is it wise for the U.S. Government to continue to throw good money after bad? Further loans, absent significant restructuring, may simply prolong the inevitable. Joshua Rauh and Luigi Zingales, associate finance professors at the University of Chicago Booth School of Business, put it best when they said, "[t]hrowing money at a drug addict only enables the addict to continue abusing drugs and ultimately shortens his life."[94] The same could be true for GM without an organized business restructuring.

The sheer amount of GM's debt obligations and the complexities involved with restructuring their business model may make Chapter 11 bankruptcy protection the most appropriate option. For the bankruptcy to be successful, however, GM must be able to secure DIP financing. This is easier said than done. DIP financing was one of the earliest casualties of the economic crisis as many of the larger players in the DIP lending business scaled back their lending.[95] Additionally, any financing needed by GM, or any of the automakers, would require a very large loan at a time when many banks are not even providing DIP financing on a small scale.[96] Because of these factors, the government should step in to act as the DIP lender of last resort for the automotive industry and any other industry whose failed bankruptcy would worsen the economic malaise.[97]

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complete in 2010, labor costs will only remain about nine dollars an hour, or seventeen percent, greater than Toyota's labor costs, according to GM's own estimates).

92. *See* Rauh & Zingales, *supra* note 91.

93. *See* Vlasic, *supra* note 88.

94. *See* Rauh & Zingales, *supra* note 91.

95. *See* discussion *supra* Part I.B

96. Free Exchange, http://www.economist.com/blogs/freeexchange/ (Nov. 12, 2008, 23:21 GMT).

97. While this paper uses GM as an illustration of when the government could step in as a direct DIP lender, it does not assert that government intervention is limited to the automotive industry. A number of different industries are capable of having extensive DIP financing needs. For example, the United Airlines and Delta Air Lines DIP funding added up to more than fifty million dollars. Harvey R. Miller, *Chapter 11 in Transition—From Boom to Bust and Into the Future*, 81 AM. BANKR. L.J. 375, 395 (2007). The Adelphia Communications bankruptcy by itself required almost $450 million. *Id.* None of these bankruptcies, however, occurred during the current financial crisis and none of these industries are potentially as vital to the American economy as the automotive industry. *See* Mitt Romney, Op-Ed., *Let Detroit Go Bankrupt*, N.Y. TIMES, Nov. 18, 2008, at A35 (noting that the automotive industry is vital to our national interest). Additionally, funding needed for a GM bankruptcy would dwarf any prior bankruptcy DIP loan. GM speculates that it needs $100 billion to finance its bankruptcy, though some speculate that it may be a negotiation tactic. Michael J. de la Merced, *Bankruptcy Could Be More Costly*, N.Y. TIMES, Feb. 18, 2009, at B1. Those familiar with the GM case note that GM "will require $40

Now, the government will certainly step in as a DIP lender for GM. The only question now is how much will it lend. On April 30, 2009, the Government forced Chrysler into federal bankruptcy protection, agreeing to lend the company another eight billion dollars.[98] Additionally Canada has agreed to provide $2.42 billion in DIP financing.[99] The amount of Government DIP financing for GM will dwarf these numbers.

1. ARGUMENTS SUPPORTING THE GOVERNMENT AS A DIRECT DIP LENDER

The most obvious argument for direct U.S. Government lending to larger distressed businesses is the current scarcity of DIP financing. DIP loans through private institutions are becoming increasingly difficult to obtain.[100] Combine that difficulty with the high cost associated with a bankruptcy like GM and obtaining DIP financing becomes a herculean task.[101] Therefore, without direct government lending, many large corporate bankruptcies could fail, deepening the current economic crisis.[102] By injecting money into the DIP lending market, the government would be helping the economy by saving jobs that would otherwise be liquidated with the company.

Government DIP lending could also benefit the taxpayer. In the past, DIP financing has been quite profitable.[103] Indeed, both the fees and the interest derived from a multi-billion dollar DIP loan would be substantial.[104] It is possible that the government, as the DIP lender of last resort, could get interest rates even higher than the 9.5% above benchmark interbank rates.[105]

DIP loans can be considered relatively safe. As discussed earlier, priming liens and priorities would protect the taxpayer losses on the

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billion to $70 billion in debtor-in-possession financing." Micheline Maynard & Michael J. de la Merced, *A G.M. Bankruptcy Would Tax the Experts*, N.Y. TIMES, May 26, 2009, at B1.

98. Jim Rutenberg & Bill Vlasic, *Chrysler Bankruptcy Plan Is Announced*, N.Y. TIMES, May 1, 2009, at A1.

99. Poornima Gupta & John Crawley, *Chrysler Files for Bankruptcy; Inks Fiat Deal*, REUTERS.COM, May 1, 2009, http://www.reuters.com/article/topNews/idUSTRE53S8F6200905 01?feedType=RSS&feedName=TopNews&sp=true.

100. *See* McCracken & Glader, *supra* note 27.

101. *See* Merced, *supra* note 97 (noting that while a GM bankruptcy could cost anywhere from $50 billion to $100 billion, the largest DIP loan on record is $8 billion).

102. It is possible that the government would use a financial firm as a conduit between it and the distressed corporation. Indeed, Edward I. Altman, a bankruptcy expert and a professor at the Stern School of Business at New York University, advocates such an approach if the government were to loan large amounts of money to GM. *Id.*

103. James J. White, *Death and Resurrection of Secured Credit*, 12 AM. BANKR. INST. L. REV. 139, 174 (2004).

104. *See* discussion *supra* Part III.A.2

105. *Id.* ("Lyondell, for instance, is paying more than twenty percent for its financing, a rate normally seen on credit cards.").

loan.[106] Effectively, the DIP lender would be at the head of the line, thus minimizing the risk of the loans and earning significant returns for the taxpayers.

2. ARGUMENTS AGAINST DIRECT GOVERNMENT DIP LENDING

The strongest argument against government backed DIP lending is the cost. The government has already allowed the United States Department of the Treasury to purchase or insure up to $700 billion of "troubled" assets.[107] The Obama administration recently unveiled a new plan that could put even more taxpayer money at risk. Treasury secretary Timothy Geithner unveiled a plan that could buy up to two trillion dollars in real-estate assets.[108] The plan was more generous toward private investors than many expected, but puts trillions of taxpayer dollars at great risk as a result.[109]

It is possible, however, that, with this much money being handed out, the taxpayers could overlook a few hundred billion dollars toward select bankruptcy DIP loans. People may simply be dulled to the amount of money being spent by the government. It is more likely, however, that the government will have difficulty extending the necessary DIP funds for larger bankruptcies. Observers have begun to speculate whether President Obama's political capital has started to dissolve.[110] Questions could arise as to whether the government is only throwing good money after bad, given that taxpayer outcry has definitely grown as the government spends more money.[111] Accordingly, the administration could face a tough time obtaining the necessary amount of money for DIP lending.

Another difficult issue in government-backed DIP financing could be deciding what distressed companies will receive governmental DIP funding. It is possible that a government DIP lending program could turn into a situation where the company that spends the most money on lobbying gets the taxpayer funds. For example, between October and December of 2008, GM and Chrysler spent a combined $7.3 million to

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106. *See supra* notes 52–55 and accompanying text.

107. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765.

108. Edmund L. Andrews & Eric Dash, *U.S. Expands Plan To Buy Banks' Troubled Assets*, N.Y. TIMES, Mar. 23, 2009, at A1.

109. *Id.*

110. John Harwood, *Obama, with a Pile of Chips*, N.Y. TIMES, Feb. 14, 2009, at WK1.

111. Sean Engel, *GOP Banks on AIG Outcry*, WASH. TIMES, Mar. 23, 2009, at A6. A recent CNN/Opinion poll finds that more than seventy-five percent of Americans would rather have GM and Chrysler go into bankruptcy before lending the companies more money. Greg Gardner, *Poll: Most Prefer GM, Chrysler Bankrupt Than Borrowing More*, DETROIT FREE PRESS, Apr. 9, 2009, at B1.

lobby for industry bailout bills in the House and Senate.[112] The process could encourage distressed companies to spend money on lobbying instead of improving their business. Additionally, it may result in only those companies that lobby for funds ultimately receiving the funds. While this empirical argument may be true, it is hasty to say it trumps other arguments without some sort of quantitative proof that only companies that participate in the lobbying process will receive DIP loans. This argument against direct government DIP lending is also less persuasive because of the amount of money actually used on lobbying. When a company like GM needs billions of dollars in loans, concern over spending a few million dollars seems overstated.

More problematic is the government's attempt to dictate GM's potential bankruptcy. GM bondholders are being pushed hard to accept a ten-percent equity stake in full satisfaction of approximately twenty-seven billion dollars in loans.[113] The UAW, however, is being offered a thirty-five percent equity stake in exchange for ten billion dollars of unsecured debt. Similar problems are already occurring with the Chrysler bankruptcy.[114] A hedge fund that invested in Chrysler may receive less than thirty percent of its investment, while a UAW health-care fund may receive a fifty-five percent equity stake in Chrysler.[115] While this favoritism is worrisome, the need for Government intervention is a necessity, for, without it, both GM and Chrysler would likely be forced into liquidation. The liquidation of Chrysler and GM and the economic waves it would create may hurt creditors even more than any sort of government favoritism.

B. *Another Approach: Using the Small Business Administration as a Model*

In 1952, a new agency was founded, the Small Business Administration (SBA).[116] The purpose of the SBA is to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns."[117] The SBA accomplishes this by directly loaning funds to small businesses and guaranteeing private loans.[118] For example, the SBA 7(a) guaranteed loan program provides a guarantee for seventy-five percent

112. Kendra Marr, *Carmakers Lobbying as They Get Bailout Money*, WASH. POST, Mar. 11, 2009, at D03.

113. Editorial, *Road Hazards Ahead*, WASH. POST, May 14, 2009, at A18.

114. *Id.*

115. *Id.*

116. Small Business Administration—Overview & History, http://www.sba.gov/aboutsba/history/index.html (last visited Mar. 28, 2009).

117. *Id.* (internal quotation marks omitted).

118. *Id.*

to eighty-five percent of the bank's loans.[119]

The SBA loan program could be a template for a similar program guaranteeing DIP loans.[120] If a bank identifies a debtor who needs DIP financing, the bank could then apply to this new DIP lending agency. Like in the SBA 7(a) program, the lender would document the loans. However, the agency must approve the loans before disbursing funds.[121] Additionally, the private lender would pay this new DIP lending agency a monthly servicing fee. The servicing fee for the SBA is 0.5%,[122] but the DIP lending agency's fee could be higher or lower.

1. ARGUMENTS FOR A DIP LENDING AGENCY

The strongest argument for guaranteeing DIP loans is that the guarantee drastically reduces the risk for banks, thus unfreezing the current DIP lending market. Arthur Newman, co-restructuring head for the Blackstone Group, recently stated that he thought that the government should guarantee DIP loans because "[t]hat would sort of open up the market."[123] Additionally, the process would likely be much more efficient than making direct government loans, as the banks already have teams experienced with DIP lending in place.[124]

A potential positive side affect of guaranteeing DIP loans is that many of the country's largest banks could improve their balance sheets. Obviously, many banks, like many industries, are struggling to survive.[125] However, DIP lending is extremely lucrative, and allowing banks to participate with little to no risk would be profitable. Therefore, a DIP lending agency could benefit both banks and distressed companies seeking financing.

2. ARGUMENTS AGAINST A DIP LENDING AGENCY

Money is the biggest impediment to a governmental DIP lending

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119. COMPTROLLER OF THE CURRENCY, SMALL BUSINESS ADMINISTRATION PROGRAMS 1 (2006).

120. A DIP lending agency does not have to be bound to the structures of the SBA loan program. The DIP lending agency could borrow features of the new Public-Private Investment Program, and guarantee a percentage of any losses stemming from a DIP loan, or subsidize a portion of the loan, thus granting lenders more flexibility in what they can and cannot do. *See* Geithner, *supra* note 23.

121. *Id.*

122. *Id.*

123. *Blackstone Executive Says US Government Should Back DIP Loans*, REUTERS.COM, Feb. 6, 2009, http://www.reuters.com/article/privateEquityFinancialServicesAndRealEstate/idUSN0646643920090206.

124. *See* Debtor-in-Possession (DIP) Financing for Corporate Bankruptcy from GE, http://www.gecfo.com/products/debtor-in-possession.html (last visited Apr. 8, 2009).

125. Jack Healy, *Stocks Slump on Corporate Woes, Indexes Fall by 3.4%*, N.Y. TIMES, Feb. 23, 2009, at B1.

agency. In the current economic crisis, the sheer amount of bankruptcies could overwhelm such a new program. If the budget for the DIP lending agency were similar to that of the SBA, it would be around $669 million.[126] This budget would make it impossible for a DIP lending agency to guarantee a loan for a company like GM. Absent a very large budget, the DIP lending agency would be forced to focus on smaller bankruptcies, although this limitation may not be a bad thing.

Problematically, a DIP lending agency puts taxpayer money at risk without the same potential for reward as a direct government DIP loan. If a number of DIP loans fail, the government bears the brunt of the risk. Additionally, the potential investment benefit for taxpayers could be reduced because the government may only be able to require a percentage fee from the interest rate charged to the DIP, while a direct government-lending fee could charge both a high interest rate and fees. Finally, a DIP lending agency's guarantee program could scare away lenders if they charged too high of a fee. Therefore, a DIP lending agency could be a difficult sell to the taxpayers.

C. *Support For a DIP Lending Agency and Direct Government Lending*

Direct government lending and a DIP lending agency are both steps that could help more companies effectively come out of the Chapter 11 bankruptcy process. While there are arguments against implementing these provisions, the need for reliable DIP lending outweighs the negative considerations. Both recommendations, direct government lending and a DIP lending agency, would address the freeze in DIP financing. Direct government lending would address larger bankruptcies, while a DIP lending agency that guarantees private loans could handle smaller DIP loans. Accordingly, a company that can secure DIP financing and smoothly exit out of Chapter 11 bankruptcy will be able to save more jobs.[127]

As of April 2009, it is almost certain that the government will "leverage the promise of taxpayer financing" as a way to restructure GM.[128] Fritz Henderson, the new CEO of GM, ominously stated that, if an out

126. *Senate Votes To Increase SBA Budget by $100 million in 2009*, REUTERS.COM, Mar. 18, 2008, http://www.reuters.com/article/pressRelease/idUS127899+18-Mar-2008+PRN20080318.

127. *Blackstone Executive Says US Government Should Back DIP Loans*, *supra* note 123.

128. Michael J. de la Merced & Jonathan D. Glater, *U.S. Hopes To Ease G.M. to Bankruptcy*, N.Y. TIMES, Mar. 31, at A1. A bankruptcy like GM would likely have many creditors. *See id.* GM may take advantage of bankruptcy mediation in order to prevent litigation and reduce costs. For a general discussion of bankruptcy mediation, see Jarrod B. Martin, *A User's Guide to Bankruptcy Mediation and Settlement Conferences*, 11 TRANSACTIONS: TENN. J. BUS. LAW (forthcoming 2009).

of court restructuring did not occur by June 1, 2009, then the company would be in bankruptcy.[129] Whether good or bad, the country is moving toward a bankruptcy landscape in which the government is the DIP lender of last resort.

V. Future Perils of DIP Financing

A. *Inflation and DIP Financing*

1. Inflation's Effect on the Players in Chapter 11

While alternative sources of DIP lending could stimulate the DIP lending market for future Chapter 11 bankruptcies, all of the theories discussed above assume that DIP lending is a relatively safe investment. In these uncertain economic times, however, this assumption may be incorrect. Since the collapse of the credit and securitization markets, the accuracy of predicted default rates on loans of all kinds has been thrown into doubt.[130] Many commentators see the failure of the bond rating agencies to accurately assess the risk of various instruments as a "but for" cause of the current economic crisis, and trust in such ratings will return at a gradual rate.[131] Individuals' trust in banks, and perhaps more importantly trust between financial institutions, has dwindled to such low levels that the credit markets have "frozen" in a way never before seen.[132] The velocity of money, in the parlance of economics, has decreased with great speed.[133] President Obama, the U.S. Congress, Sec-

129. Merced & Glater, *supra* note 128.

130. *See* Michael Aneiro, *Credit Markets: Corporate Bonds Sag Ahead of Earnings Season*, WallStreetJournal.com, Apr. 7, 2009, http://online.wsj.com/article/BT-CO-20090407-712829.html; Emily Chasan, *NYU's Altman Sees 2009 Default Rate Doubling*, Reuters.com, Sept. 23, 2008, http://www.reuters.com/article/Restructuring08/idUSTRE48N0KK20080924.

131. *See generally* Kristofor W. Nelson, *Rough Waters for the Ratings Companies: Should the Securities Ratings Companies Be Held Liable for Investor Reliance in the Wake of the Real Estate Meltdown of 2007–2008?*, 63 U. Miami L. Rev. 1177 (2009) (discussing ratings agency accountability).

132. Andrew Leonard, *Why the Threat of Systemic Meltdown Is Real*, Salon, Sept. 24, 2008, http://www.salon.com/tech/htww/2008/09/24/in_fear_of_the_ted_spread/print.html. Leonard discusses in this article the "TED spread"—the divergence between three-month U.S. Treasury bills and three-month LIBOR interests rates—and the signaling by its increase that trust among big banks has declined. *Id.* This differential in rates is also important to the effects of inflation on Chapter 11, discussed below. *See* Tom Petron & Walter Hamilton, *Financial Crisis: Dissension on Capitol Hill*, L.A. Times, Sept. 27, 2008, at A1; Brian Keogh, *Libor Rises, Commercial Paper Slumps as Credit Freeze Deepens*, Bloomberg.com, Oct. 2, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=A0JbUyhTA71Y&refer=home.

133. The velocity of money is "the average frequency with which a unit of money is spent in a period of time." 4 J.S. Cramer, The New Palgrave: A Dictionary of Economics 601–02 (1987). It is relevant in this discussion because inflation is directly related to the velocity of money by the Equation of Exchange. *See, e.g.*, Helmut Frisch, Theories of Inflation 218 (1983) (giving as the first example in the section entitled "Some traditional explanations of inflation" the equation of exchange, Prices multiplied by the Volume of Transactions equals the

retary of the Treasury, and Federal Reserve Bank's approach to fixing the banking and financial system has included tremendously increasing the money supply in a very short time by a variety of means, some of which have never been used.[134] This "systemic-fix-by-injecting-liquidity" method is likely to lead to rapid inflation once the velocity of money increases, and the credit markets "unfreeze."[135] The denizens of our current recession, rapid erosion of trust in financial institutions, and the massive increases in the money supply aimed at preventing a financial systems failure—which is likely to cause inflation—pose dramatic changes to the landscape of DIP finance. The two-ton-elephant in the room is rapid inflation. Inflation will likely follow this money-supply increase when the velocity of money slows down to more normal levels.[136] Rapid inflation threatens to shake up the Chapter 11 process,

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Money Supply multiplied by the Velocity of Money); PETER KENNEDY, MACROECONOMIC ESSENTIALS 153 fig.9.5 (2nd ed. 2000) (stating graphically the direct relationship between money supply and inflation, with velocity of money as constant); Mark Gongloff, *Best Check on Inflation: Broken Banks*, WALL ST. J., Mar. 20, 2009, at C1 ("With the Fed training a *monetary* fire hose on the financial system, many in currency and other markets are getting itchy about inflation."). Gongloff goes on to say that until a banking fix, the velocity of money is unlikely to increase, keeping inflation under control. Ironically, the banking sector's enormous market gains since this article was published may now give greater cause for alarm as to inflation. Gongloff, *supra*.

134. Alan Bush, *Quantitative Easing and Treasury Note Futures*, INSIDE FUTURES, Apr. 3, 2009, http://www.insidefutures.com/article/99132/Quantitative%20Easing%20and%20Treasury%20Note%20Futures.html (discussing the use of "quantitative easing" to increase money supply further when rate cutting has proven ineffective, and rates are "essentially at zero and it is impossible to cut them further"). Although experts are in disagreement about the chances of rapid inflation, many prominent commentators make convincing arguments for inflation. *See* Rich Miller, *Bernanke Bet on Keynes Has Meltzer Seeing 1970s-Style Inflation*, BLOOMBERG.COM, Apr. 12, 2009, http://www.bloomberg.com/apps/news?pid=20601100&sid=A8tjEzB.d.kU&refer=germany ("If history is any guide, says Allan Meltzer, the effort will end in tears. Inflation 'will get higher than it was in the 1970s,' says Meltzer, the Fed historian and professor of political economy at Carnegie Mellon University in Pittsburgh. At the end of that decade, consumer prices rose at a year-over-year rate of 13.3%.").

135. Some market indicators point to the beginning of inflation already. *See, e.g.*, Frank Tang & Paul Lauener, *Gold Near Three-Week High n Weak Dollar, Inflation*, REUTERS.COM, Mar. 19, 2009, http://www.reuters.com/article/hotStocksNews/idUSTRE52I1T220090319. Indeed, Tang and Lauener go on to state that

> [g]old rose to its highest level in nearly three weeks on Thursday as the dollar tumbled and inflation concerns flared after the U.S. Federal Reserve unveiled plans to spend $300 billion on long-dated Treasuries . . . . Gold traditionally moves in the opposite direction to the dollar as it is often used as a currency hedge, while a weaker dollar makes gold cheaper and more attractive for holders of other currencies.

Id.; *see also* Eileen Alt Powell, *Growing Unease About Dollar as U.S. Deficits Grow*, CLEVELAND.COM, Apr. 6, 2009, http://www.cleveland.com/world/index.ssf/2009/04/06/ (discussing unease over weak dollar).

136. Brian S. Wesbury & Robert Stein, *Don't Forget Inflation*, FORBES.COM, Mar. 3, 2009, http://www.forbes.com/2009/03/23/inflation-deflation-fed-opinions-columnists-ppi-cpi.html. Most concerning is the prospect of government policies that fail to stop increasing the money supply

which will ultimately affect the terms and availability of DIP lending.[137]

Changes to DIP lending partially come from a proportional increase in value of the collateral to the loans secured by that collateral.[138] In an inflationary environment, the goods against which inflation are measured appreciate in lock step with inflation, as the market price for those goods goes up.[139] The prices of goods that are not used to measure inflation and the prices of services and intangibles also go up as the dollar becomes weaker.[140] Widget manufacturers need to pay higher prices in this inflationary environment to make new widgets. Also, the benefit of higher profits is offset because inflation makes profits consist of less-valuable dollars. But secured debt, which consists of a fixed dollar amount before an inflationary cycle begins, becomes a relatively smaller percentage of the debtor's borrowing base because other debts that are not fixed in amount increase.[141] Due solely to inflation, which increases the dollar value of the debtors collateral, some under-secured claims will become fully secured.[142] As a result, inflation tends to benefit junior lien holders and under-secured creditors.

Another important effect of rapid inflation is that pre-inflation interest rates become extremely favorable to the debtor. The debtor can use the cheap pre-inflation loan funds to make greater profits over the term of the loan because inflation drives up the interest rates for new loans. This business edge may be considerable. Lenders that lend money in strong dollars and get repaid in weak dollars stand to lose money. A lender in this position would prefer to be paid back in full as quickly as possible. Depending on the level of inflation, repayment—even in full—at the agreed-to interest rate over a lengthy timeframe could be a calamitous loss if higher-yield investments exist.[143] Unsecured creditors are

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soon enough, leading to an environment where the velocity of money picks back up while the money supply is still going through the roof.

137. Also, both scenarios would be "cases of first impression"; there has been neither high inflation since the advent of modern DIP lending, nor any significant default rate.

138. *See* 11 U.S.C. § 506(a) (2006) (providing that creditors with a security interest in collateral are given a secured claim to the extent of the "value of such creditor's interest in the estate's interest in such property"). The "estate's interest in such property" will increase as the market prices and replacement prices for the collateral increase.

139. *See* FRISCH, *supra* note 133, at 9.

140. *Id.*

141. A business's "borrowing base" is all the collateral that lenders can take a security in for loans. *See, e.g.*, *RAM Energy Resources Reports Borrowing Base Reaffirmed by Commercial Lenders*, FORBES.COM, APR. 4, 2009, http://www.forbes.com/feeds/businesswire/2009/04/01/businesswire122728393.html (announcing lender reassessment and approval of the $175 million value of RAM Energy's borrowing base).

142. *See* § 506(d). Subordinate liens are void if the value of the creditor's interest in the collateral is zero. *Id.* If there is value available for a subordinate lien holder in the debtor's collateral, the subordinate lien holder has a lien that survives bankruptcy in that amount. *Id.*

143. Lenders can buy treasury bills and limit risk of default to nearly zero. In an inflationary

greatly disadvantaged by the effect of inflation on interest rates, as the interest they earn provides inadequate protection against the risk of default and inflation. However, unsecured creditors might fare better if inflation allows the debtor to stay in business and pay back a larger percentage of what they are owed than in a non-inflationary environment where they might get only a few cents on the dollar in liquidation. In the end, the unsecured creditor is almost never happy in bankruptcy anyway; inflation should not significantly change his or her interests.

Secured creditors interested in getting paid out early on loans affected by rapid inflation have a huge incentive to have the debtor liquidate their collateral. They also would like to have their claims purchased in full and paid up front by the debtor, potentially with a DIP lender's cash.[144] Thus, inflation gives more secured creditors an incentive to either push for liquidation early in a Chapter 11 case or quickly vote against any plan. By voting against a plan, the creditor could force a "cram down" and a resulting lump sum payment "of at least the value of such holder's interest in the estate's interest in such property."[145]

Debtors may find it advantageous to stay in business during an inflationary period for more reasons than simply retaining favorable interest rates on unsecured loans. The more plentiful, weaker dollars a business can earn to pay back strong dollars borrowed means that debtors will emerge from bankruptcy more quickly. Further, if debt is paid down in weak dollars, the debtor effectively "buys" its encumbered property from lenders at favorable pre-inflation "prices" (the loan amount) and with money borrowed at low pre-inflation interest rates. The debtor can exploit its pre-inflation position by acquiring the means—be it the factory, inventory, below-market leases, or favorable contracts—to earn large profits.

Simply put, the debtor can realize large gains by staying in business in an inflationary environment. Secured lenders, who can be paid out in full on the effective date of a plan,[146] can find a way out of bad interest rates through bankruptcy, and more debt becomes secured by the

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environment, the high yield on treasury bills makes the prospect of lending money to a business for a lower return *and* a higher risk of default very unappealing. *See* Federal Reserve: Yields on Actively Traded Non-Inflation-Indexed Issues, http://www.federalreserve.gov/releases/h15/data/Monthly/H15_TCMNOM_Y10.txt (last visited May 27, 2009) (indexing the annual yield on ten-year treasury bills since 1953, and showing a high of 15.32% for September 1981).

144. § 363(k). Section 363(k) allows a secured creditor to "credit bid" the amount of its secured claim in a sale of collateral securing its claim. This helps ensure a fair market price in a liquidation sale. In an inflationary environment, the collateral would very likely sell for more than this amount, and, if for some reason it did not, a secured creditor could credit bid the amount of its claim and then sell it later, at an inflated market price.

145. *Id.* § 1129(b)(2)(a)(i)(II).

146. *Id.*

increased value of the debtor's collateral in nominal dollars due to inflation. Unsecured creditors lose big because interest rates on the money they lent the debtor were locked in before inflation, but may fare better by receiving more return-on-the-dollar than would be available in a liquidation.[147] To avoid liquidation, the debtor needs funding to work through the restructuring. This makes the DIP lender a crucial party. The large amount the debtor stands to gain also makes DIP financing worth paying a high interest rate.

2. WHY THE NEW DIP LENDERS CAN EXPECT BIG RETURNS ON THEIR MONEY

Debtors stand to gain significantly from reorganizing successfully in Chapter 11 during times of inflation. In order to do so, however, they will need financing. Their secured lenders are not likely to provide more funds since they benefit enormously from liquidation; providing funds for reorganization will make early liquidation less likely. At the very least, a secured creditor could force a cram down, and this kind of delay goes against the notion of giving new money to the debtor.

The debtor might believe that staying in business is worth paying high interest rates on a new DIP loan if the profit margin of the business increases. In addition, debtors are incentivized to stay in business by keeping favorable interest rates on their unsecured loans—not to mention prices on unexpired leases and executory contracts that have become quite favorable after inflation causes market prices to climb—and the prospect of making greater profit numbers in business going forward due to the higher prices for the goods or services it sells.[148] This inflation will allow a debtor to pay down debt faster than would otherwise be possible and increase its stake in the equity of the reformed debtor. Simply put, debtors will be able to capture a huge amount of value by reorganizing, and DIP lenders will know this.

DIP lenders may also see opportunity in making such loans. Assuming a borrowing base that increases in nominal dollars as rapid inflation proceeds, this increase in available collateral value might be as high as fifteen percent per year over the pre-inflationary value.[149] Indeed, this rate was the prevailing inflation rate during the last heavily

147. Douglas Baird et al., *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* 16 (Yale IFC Working Paper, Paper No. 05-29, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=866865&rec=1&srcabs=971566 (noting that for businesses that have assets valued above five million dollars, unsecured creditors will typically collect about sixty cents on the dollar).

148. § 365(a).

149. *See supra* note 133 and accompanying text.

inflationary period in the early- to mid-1980s.[150] DIP lenders could plan to take security interests in more collateral if courts give them priming liens.[151] Some forms of collateral, such as inventory, will "appreciate by inflation" faster than other forms, such as equipment, which typically depreciates with use. However, lenders account for use depreciation when making secured loans, so the net effect of inflation on equipment will still increase the "new value" available to pay creditors.[152] Furthermore, encumbered accounts receivable will become less onerous for the debtor's creditors to pay off in weaker dollars, and they will likely be collected faster and with greater frequency, making them a more attractive form of collateral.

The debtor has a tough task when negotiating with potential DIP lenders. The main negotiations will center on *how* high the interest rates on the DIP loan will be. Inflation drives up interest rates for all loans.[153] The debtor's need for funds will also weaken its bargaining position. New DIP lenders will likely want very high rates for their loans. By taking note of the impending inflationary climate and uncertain court valuations of the debtor's property, savvy DIP lenders can demand both higher interest rates on the new value given to debtors and shorter loan terms. DIP lenders may be able to get super priority treatment under the Bankruptcy Code or prime secured lenders.[154] A secured creditor should fear this scenario and therefore may have an incentive to cooperate by loaning new funds if the loan will save time and the estate is not likely to become administratively insolvent.[155] However, because courts will only grant priming liens if no other financing option is available, the court would likely ask if the debtor sought financing at prevailing market interest rates.[156] Assuming the debtor can find another lender by soliciting loans with market interest rates, secured lenders can expect to remain first in line.

Since goods are a safe store of value in an inflationary period, as described above, DIP lenders might also insist on agreements that give them ownership of collateral free and clear of liens if the debtor defaults, even if that means giving secured creditors cash payment for the full

150. *See* Federal Reserve: Yields on Actively Traded Non-Inflation-Indexed Issues, *supra* note 143.

151. If there is no other means of obtaining financing, a new lender to a debtor in possession can get a super priority administrative claim and a lien that primes, or gets repayment priority ahead of, all other secured creditors. § 364(c)–(d).

152. *In re* Desjardin, 340 B.R. 790 (Bankr. S.D. Tex. 2006).

153. Fernando Alvarez et al., *Interest Rates and Inflation* 1 (Fed. Reserve Bank of Minn., Research Dep't, Working Paper No. 609, 2001).

154. § 364(c)(1).

155. *Id.* §1129(a)(9).

156. *Id.* § 364(c)(1).

amount of their liens. DIP lenders who "loan to own" might see opportunity in reselling collateral or in acquiring equity in business that own certain collateral types. This collateral, and the business that continues to use it, will "appreciate" quickly in inflationary environments when the market will bear a price high enough to outpace inflation and represent a profit in real dollars when collateral or equity shares are sold in the future.

The topic of carve outs in the first-day pleadings will probably become a contentious battle between the new DIP lender and the secured creditors because the parties have sharply opposing interests.[157] Negotiations may break down, and the breakdown can weaken the debtor's bargaining chip of limiting the uncertainty of administrative expenses by waiving surcharges.[158] Section 506(c) provides that after reasonable expenses of administration that benefit the secured creditor are paid to the debtor, the lien holder must receive the remainder of the sale price of collateral. As discussed above, inflation will increase this residual amount of sale value considerably.

B. *Legal and Economic Effects on DIP Default Risk*

Another current challenge in DIP lending is the potential increase in the default risk of DIP loans. Although DIP loans have historically enjoyed low default rates, the 2005 BAPCPA amendments to the Bankruptcy Code could increase risk of default on DIP loans in the current environment.[159] These amendments limit the debtors' exclusive right to file a reorganization plan to eighteen months.[160] Under the prior law, judges could extend the debtors' exclusive rights for as long as they felt was reasonable.[161] Now, after eighteen months, other parties in interest can submit competing reorganization plans.[162] During the exclusivity period, other parties can also lobby to reject the debtor's plan and begin to negotiate an alternative plan amongst each other knowing that opportunity to submit that plan is only eighteen months away at most.[163] This situation could cause an increase in DIP loan defaults, as debtors may not exit the bankruptcy prior to the maturity of the loan.[164]

Another possible cause for an increase in DIP loan default risk is that credit markets have slowed due to the economy and financial mar-

157. *See* Gen. Elec. Credit Corp. v. Levin & Weintraub, 739 F.2d 73 (2d Cir. 1984).
158. Hartford Underwriters Ins. Co. v. Union Planters Bank, 530 U.S. 1 (2000).
159. FAHY, *supra* note 55, at 6.
160. § 1121(d)(2)(A).
161. FAHY, *supra* note 55, at 6.
162. *See* § 1121(d)(2)(A).
163. *See* Century Glove Inc. v. First Am. Bank of N.Y., 860 F.2d. 94 (3rd Cir. 1998).
164. FAHY, *supra* note 55, at 6–7.

ket instability. Accordingly, debtors may have difficulty obtaining exit financing loans made to fund the restructuring and repay the DIP loan and pre-petition creditors.[165] Without an exit loan, debtor companies will be unable to successfully reorganize, repay creditors, and exit bankruptcy. DIP loans will, therefore, exceed their maturity dates and go into default. This default leaves the lenders with the decision to (1) extend exit financing to the debtor, (2) extend the maturity for the DIP loan with the hope that the debtor can find either exit financing or a buyer for the company, or (3) call in the loan and force the company to liquidate its assets to repay the loan balance. None of these options are ideal for DIP lenders. Exit financing does not have the same legal protections as DIP loans and is usually a longer term commitment, which results in higher risks.[166] Likewise, extending the maturity of the DIP loan increases the lender's risk because an exit loan or buyer may not materialize.

Finally, in a default or asset sale, the lender's protection consists of the value of the collateral securing the loan. In this economy, ensuring adequate collateral coverage may be difficult.[167] The borrowers' receivables may quickly drop in value as their customers' businesses struggle, or the market to purchase the borrowers' inventory may diminish.[168] Should DIP lenders overestimate the value of their collateral, they face the real risk of not being fully repaid.[169]

Should DIP loans begin to default at never before seen levels, the new and historical lenders may rapidly withdraw from the market. This exodus could cause the market for DIP lending to "freeze" again. One of the main incentives for DIP lending in this uncertain market is the historically low risk of DIP loan defaults. The legal effects of BAPCPA, the lack of exit financing, or the uncertainty of asset valuation could

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165. McCracken & Glader, *supra* note 27.

166. No section of the Code provides the same protections to lenders of exit loans as provided to DIP lenders in Section 364. *See* § 1142.

167. FAHY, *supra* note 55, at 6.

168. For example, Delphi, an auto parts supplier, filed for bankruptcy in 2005 and has not yet exited. Delphi's biggest customer is GM. Caroline Humer, *Delphi Survival Move May Signal Bankruptcy Shift*, REUTERS.COM, Nov. 19, 2008, http://www.reuters.com/article/reutersEdge/idUSTRE4AI7LQ20081119. The liquidation value of Delphi's receivables and inventory presumably are much less because American automobile companies, either bankrupt or on the verge of bankruptcy, may not be able to repay their receivables and the demand for Delphi's products decreased as result of the economic downturn.

169. The Winstar Communications DIP loan illustrates this point. Winstar was the previously referenced loan DIP loan not to be repaid in the last twenty years of Moody's tracking of DIP loans to large publically traded companies. Winstar was a telecommunications company; while the company was in bankruptcy, the telecom industry crashed. After the sale of the companies' assets, the DIP recovery was estimated to be only twenty percent to thirty percent. FAHY, *supra* note 55, at 4.

cause a rapid increase in DIP lender withdrawal, resulting in a more permanent freeze to the DIP lending market.

VI. Conclusion

While these new or lesser-used resources for DIP lending may meet current and future demand, other legal and economic factors could quickly derail this process. That being said, the future of DIP lending simply remains uncertain. The historic safety of DIP default rates, combined with the increase in loan prices, should attract investors to the market.

Without DIP loan to maintain business operations during bankruptcy, companies may be forced to liquidate rather than reorganize under Chapter 11. In order to stop the "Great Recession" from worsening, alternative sources of DIP lenders must emerge to help fill the new void. Each of the participants discussed above—smaller banks, equity and hedge funds, and the government—could take a more active and prominent role in the future of DIP lending. Each participant faces both unique and universal challenges, but each could also profit from the demand for DIP loans in the current conditions. If this theory holds true, the economy as a whole would benefit significantly. More companies could survive the "Great Recession" and continue to provide much-needed products, revenue, and jobs to this economy.