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Impact of COVID-19 on the DIP financing market in the US

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In a Chapter 11 bankruptcy, debtor-in-possession (DIP) financing is often an essential component of the debtor's ability to maintain sufficient liquidity to complete a successful reorganisation. DIP lending has typically been viewed as extremely safe credit, with low default rates and high returns. DIP lenders extend credit on the assumption that they will recover in full and at a premium, as a facility is often accompanied by a package of protections, including priority claim treatment under the Bankruptcy Code, priming liens on collateral, tight covenants, a negotiated DIP budget, robust reporting and bankruptcy milestones or 'case controls'.

Just as COVID-19 is impacting the leveraged finance market, it is also affecting the DIP financing sector. In recent months, a number of debtors previously on paths to successful reorganisations have defaulted on their DIP facilities, while others have indicated in court filings or hearings that they may be unable to repay their DIP obligations. DIP lenders that depend on going concern value for repayment have always carried a certain amount of risk, if only because repayment could be delayed by developments in the case. By contrast, DIP lenders that rely on the liquidation value of their collateral have historically been protected, based on their senior lien position; however, they too can experience hardship when faced with an unexpected drop in asset value. Over the past few months, some DIP lenders have found themselves grappling with both issues simultaneously.

In late February, Sanchez Energy Corporation, an oil exploration and production company that, along with its affiliates, filed for bankruptcy in August 2019, sought a 90-day extension of exclusivity to file a plan of reorganisation, expressing optimism about its progress in crafting a value-maximising plan within the deadlines set under its DIP facility. Less than a month later, facing a combination of plummeting commodities prices and unstable financial markets, the debtors had triggered multiple DIP defaults. Forced to take drastic action to retain their employees and preserve their business as a going concern, the debtors reached a settlement with their DIP lenders, which were now the unenviable holders of the fulcrum security. Pursuant to that agreement, $150m in DIP obligations will be exchanged for stock of the reorganised company, with estimated recoveries in a range of 11 percent to 53 percent. A confirmation hearing in the debtors' cases is scheduled for 30 April.

Similarly, in mid-March, CraftWorks Holdings found itself unable to proceed with its bankruptcy as planned. The company and its affiliates, operators and franchisors of steakhouses and breweries, filed for Chapter 11 on 3 March with a senior lender agreeing to provide $23m in DIP financing and a stalking horse bid for the purchase of the company's assets. Almost immediately after the filing, the debtors' business operations and cash flow were hit by the effects of COVID-19. On 18 March, the DIP lenders served CraftWorks with a notice of default, terminating their financing commitments and the debtors' ability to use cash collateral. Forced to cease the operation of their restaurants and terminate almost all their employees, the CraftWorks debtors quickly negotiated to obtain $4m additional interim DIP financing to pay critical expenses, in hopes of avoiding a conversion to Chapter 7. The DIP lenders agreed to withdraw their termination notice and make a number of other concessions with respect to current payment obligations, including permitting PIK interest, adding adequate protection payments to the balance of adequate protection claims, and adding fees and expense claims of the DIP agent and DIP lenders to outstanding DIP obligations. Although the debtors have expressed cautious optimism that they will be able to restart their business and complete their reorganisation, the impact on the enterprise value of the business and resulting creditor recoveries are unclear.

In a number of other recently filed cases, debtors have struggled to implement their prepackaged bankruptcies in the face of COVID-19 headwinds. Pioneer Energy Services, an oil & gas drilling and production services company, filed a prepackaged bankruptcy in March that was supported by a $75m DIP credit facility. By April, an ad hoc group of noteholders and backstop parties sought to challenge the viability of their restructuring support agreement (RSA) and backstop commitment with the debtors, arguing that recent dramatic changes to the debtors' enterprise value potentially created a material adverse change that would excuse the noteholders' performance under the agreements. The bankruptcy judge has allowed the debtors to proceed to a confirmation hearing while engaging in mediation with noteholders on these issues, and the DIP lenders have extended the plan confirmation milestone in the DIP facility accordingly. Meanwhile, a few noteholders have filed objections to the plan as well as to the DIP amendment. If the objections have merit or if the mediation is unsuccessful, the debtors face the prospect of litigation over the valuation of the company's business and a contested confirmation hearing with an uncertain outcome.

The VIP Cinema Holdings debtors were unable to successfully navigate through the recent downturn. The multinational manufacturer of luxury recliner seating for movie theatres filed prepackaged Chapter 11 proceedings in February, which included a $33m DIP facility. By 3 April, VIP Cinema's RSA had been terminated and the DIP facility was in default. Forced to abandon their prepackaged plan, the debtors are negotiating a forbearance with their DIP lenders to enable them to wind down their business and monetise their assets, hoping to generate sufficient cash to repay their DIP obligations and other administrative claims.

Although it is too soon to ascertain the full impact of the current economic climate on the DIP financing market, if DIP lenders continue to face defaults, they are likely to become more cautious in extending credit, particularly to industries and asset classes impacted by COVID-19. In addition to demanding tighter covenants, DIP budgets and milestones, more aggressive collateral protections such as roll-ups and cross-collateralisation, and higher interest rates, DIP lenders may become hesitant to provide financing without more collateral cushion and a clear path to reorganisation. However, with careful planning and structuring, DIP financing can still be a helpful tool to help viable debtors restructure and preserve value for stakeholders. ■