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LENDING STRATEGIES

Is It Time to Become a Distressed Lender? How PE Sponsors Can Pivot to a Bankruptcy-Lending Strategy While Managing Attendant Risks

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As its impact continues to expand, the coronavirus outbreak is likely to threaten a wide range of industries given the complexity and intricacy of the global economy. Certain industries (*e.g.*, retail, hospitality and travel) are already suffering due to decreased economic activity and supply chain disruptions. Every industry will undoubtedly face tremendous challenges as it attempts to recover from the pandemic, the full effect and timing of which are largely not yet understood.

Although established PE strategies such as leveraged buyouts, venture capital and mezzanine investing are not completely dependent on general economic cycles, their returns are often positively correlated to economic trends. As such, finding investment opportunities during an economic downturn with an appropriate risk profile may prove challenging for traditional investment vehicles.

The reverse is true of distressed lending, however, as a weak economy typically generates increased investment opportunities. This article describes opportunities available to PE sponsors to pursue substantial returns with managed risk through distressed lending. Specifically, the article outlines several approaches to distressed lending before undertaking a deeper dive into the relative merits and issues with post-petition debtor financing (DIP Financing), as well as certain considerations when raising a distressed fund.

See our two-part series on direct lending funds: "Structural Approaches to Address Liquidity Considerations and Ensure Regulatory Compliance" (Dec. 3, 2019); and "Five Structures to Mitigate Tax Burdens for Various Investor Types" (Dec. 10, 2019).

Distressed Investing Trends

Many PE firms have been building up distressed debt funds over several years, keeping sizeable portions of them on hold for a downturn. The "dry powder" among distressed debt funds hit a record $77 billion globally in 2019, meaning there is no shortage of cash available. In addition, distressed debt funds have raised $130.6 billion across 128 strategies in the last five years to invest in troubled companies. As of early 2020, there were at least 50 distressed

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funds in the market that were collectively looking to raise a total of $34.8 billion.

The number of funds also continues to grow as sponsors seize opportunities introduced by the current economic conditions. General Atlantic announced its intention to team up with credit investor Tripp Smith to launch a nearly $5-billion fund to provide financing to companies hit by the coronavirus pandemic. J.P. Morgan Asset Management also launched its first-ever special situations fund in November 2019, raising just over $1 billion to invest in stressed, distressed and event-driven situations across North American and European private and public credit markets.

For more on PE industry trends, see "JPM Report Identifies Opportunities for PE, Private Credit and Other Alternative Investments" (May 5, 2020); and "Significant PE Growth in 2019 and an Evolved 2020 Approach to ESG and Technology, Among Others" (Apr. 14, 2020).

DIP Financing Versus Other Distressed Lending Strategies

There are three main ways of investing in distressed debt:

- secured lending;
- buying debt on the secondary market; and
- DIP Financing.

Secured Lending

The most direct way of investing in a distressed company is via secured lending, which involves providing capital in exchange for liens on a company's assets. Companies receiving the loans are usually overleveraged and otherwise unable to raise capital, with the terms of the secured loans commensurate with the risk assumed.

Lenders typically protect their interests in by including contain control provisions – such as covenants and prepayment penalty provisions – in the secured lending agreements. Those provisions provide the lender with control over the company and deter involvement from other investors, both before and after any potential bankruptcy filing.

There is risk, however, if a lender fails to properly record its lien and the company files for bankruptcy. In that case, the lender will likely face potential challenges as to the validity of the liens. In addition, a prepetition lender that attempts to "shore up" any defective recordings on the eve of a bankruptcy filing could face "preference risk" under Section 547 of the U.S. Bankruptcy Code (Code). That provision allows a debtor-in-possession to recover any transfer of interests of the debtor in the 90 days before a bankruptcy filing. Secured lenders also face potential liability based on theories of fraudulent conveyance, both under state law and the Code.

See "Credit Fund Specialist Discusses Trends in Fund Formation and the Credit Fund Space" (Aug. 23, 2018).

Buying Debt on the Secondary Market

Another option for sponsors to consider is buying distressed debt on the secondary market. There is usually an oversupply of distressed debt during economic downturns, which enables many investors to purchase distressed debt below par. The fundamental

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premise is the same as when an investor lends directly: accumulate a company's debt to gain negotiating leverage and influence management decisions about restructuring options.

The risks of buying debt on the secondary market are similar to those faced by direct lending – namely the potential attack on the validity of liens. As such, it is critical that an investor conduct appropriate due diligence before purchasing secured debt.

See "A Practical Guide to the Mechanics of a Secondary Transaction and Attendant Considerations" (Mar. 3, 2020); and "Current Trends in the PE Secondary Market and Key Differences Between Europe and the U.S." (Oct. 22, 2019).

DIP Financing

Purpose and Process

Lack of liquidity is a main driver of bankruptcy filings, and ensuring the availability of cash to maintain a debtor's operations until its assets are sold or it is successfully reorganized may be the most important aspect of a Chapter 11 bankruptcy case. Also, a debtor cannot use "cash collateral" after a bankruptcy filing without the consent of its secured lender(s). Therefore, the ability to obtain financing immediately after a bankruptcy filing can determine the success or failure of the business.

Absent special protections, lenders would be reluctant to provide financing to companies post-petition. As a result, the Code is designed to encourage creditors to lend to debtors. A debtor seeking to borrow cash outside the ordinary course must obtain approval from the bankruptcy court and comply with Section 364 of the Code, which governs obtaining credit in bankruptcy cases.

DIP Financing agreements are structured similar to traditional loans, but with some special bankruptcy "bells and whistles." DIP Financing is typically negotiated during the weeks leading up to the bankruptcy filing and often approved by a bankruptcy court at the first hearing in a bankruptcy case within a few days of filing. DIP Financing is approved on an interim basis to provide the debtor with immediate access to cash to satisfy ongoing working capital needs for the initial stages of the case, and subsequently approved on a final basis so the debtor is adequately funded as it reorganizes.

Priority in Bankruptcy

Section 364 of the Code outlines the priority a debtor provides a lender to obtain DIP Financing:

- *Unsecured Financing With Administrative Claim*: treated pari passu with all other parties providing goods and services to the debtor post-petition;
- *Unsecured Financing With Superpriority Claim*: allows it to be paid ahead of all other administrative claims;
- *Financing Secured by Liens on Unencumbered Assets*;
- *Financing Secured by Junior Liens on Encumbered Assets*; and
- *Financing Secured by Senior or Equal Liens on Encumbered Assets*: priming liens on property subject to existing liens.

A debtor cannot simply provide a priming lien in every bankruptcy case, as Section 364 requires a debtor to demonstrate that

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funding is not available on an unsecured basis or by junior liens first. In addition, an existing secured creditor must consent to being primed, or the debtor must demonstrate the existing lender is adequately protected from the diminution in value of its collateral. Adequate protection is usually provided to primed lenders through periodic cash payments and other control mechanisms, such as case milestones.

The majority of DIP Financing transactions are provided by existing secured lenders motivated to protect their liens from being primed by a new lender, or because a debtor cannot find other willing lenders – known as "defensive DIPs." On the other hand, "offensive DIPs" are provided by new lenders that believe the company has sufficient unencumbered assets to secure financing or that a priming lien can be obtained on a debtor's assets.

See "Can Private Funds Make DIP Loans to Bankrupt Companies in Which They Also Own or Acquire Equity Interests?" (Mar. 11, 2009).

Benefits

In summary, DIP Financing provides a lender the opportunity to invest on its own terms and with special bankruptcy protections, while also controlling the investment horizon by establishing case milestones. In addition, a DIP Financing lender gets the benefits of a court order containing a finding of good faith and the protection from attacks by third parties against the validity of the lender's liens.

Specifically, DIP Financing provides some of the following unique benefits that are not seen in other financing scenarios:

- *High Interest Rates*: as high as approximately 13 percent;
- *Fees*: including commitment fees, exit fees, due diligence fees and legal fees;
- *Protections*: including weekly reporting; right to inspect and appraise collateral; limitations on the use of loan process and budget variance limitations; restrictions on the sale of assets; strict default provisions; relief from the automatic stay to allow exercise of rights and remedies upon a default;
- *Automatic Perfection:* DIP Financing orders typically provide that the financing is automatically perfected without the need to file a UCC statement;
- *Challenge Rights*: parties-in-interest usually are given a fixed deadline to challenge the validity of the lender's prepetition liens. The lender can also negotiate a cap on the use of the DIP Financing proceeds to investigate the lender's prepetition liens;
- *Roll-Up*: effectively transforms the existing lenders' prepetition claims into a post-petition claim with all of the same protections provided under the DIP Financing;
- *Cross-Collateralization:* allows the prepetition lender to receive a security interest in assets acquired after the bankruptcy filing to secure both debt incurred prepetition and the DIP Financing;
- *Milestones*: a lender typically has leverage to dictate the progression of a debtor's bankruptcy case by requiring deadlines for (1) a debtor to obtain court approval of the DIP Financing; (2) a sale timeline, including the filing of a motion, obtaining bids, conducting an auction, obtaining a sale order and closing a sale; or (3) in the

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case of a reorganization, a deadline to obtain approval of a disclosure statement and confirmation of a plan; and

- *Credit Bidding*: as a secured lender, a DIP Financing lender can credit bid its debt in connection with the sale of any of the debtor's assets, as a strategy to either own the assets or protect its collateral.

When a successful reorganization occurs, a DIP Financing lender also has an opportunity to continue investing in a debtor upon its emergence from bankruptcy through conversion of its DIP Financing to exit financing or by converting a portion of the debt to equity as part of any bankruptcy plan.

See "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy? (Part One of Two)" (Feb. 4, 2020).

Potential Risks

Although DIP Financing provides tremendous benefits to a lender, it is not without risks.

Similar to a traditional loan, a lender must inspect and value the collateral, existing liens and financials of the debtor. A lender should also strive to understand the debtor's bankruptcy exit strategy. If a sale is contemplated, the lender should determine if there is sufficient interest in the debtor's assets to satisfy payment of the DIP Financing. If the debtor is pursuing a reorganization, the lender should scrutinize whether the debtor will have sufficient exit financing to pay off the DIP Financing – provided, of course, the lender is unwilling to provide that exit financing.

In addition, there is always a risk that a debtor may suffer substantial post-petition losses warranting conversion to Chapter 7 or that the debtor will engage in conduct warranting the appointment of a trustee to operate its business. The result under both scenarios is that the lender will have an unknown trustee operating or liquidating the debtor's business, typically with differing interests than the lender. Fortunately, a well-drafted DIP Financing agreement considers either scenario a default and allows a lender to pursue its rights and remedies under the credit agreement immediately.

See "How Can Private Funds That Invest in Distressed Debt Keep Their Strategies and Positions Confidential in Light of the Disclosures Required by Federal Rule of Bankruptcy Procedure 2019(a)? (Part One of Three)" (Aug. 27, 2009).

Thoughts on Establishing a Distressed Fund

Due to mandates in traditional PE funds, distressed investing is likely prohibited or limited to a small portion of fund assets. Trading in distressed securities is also highly inefficient, partly because of forced selling. When a security defaults or is downgraded, investors with mandates that do not permit holding those securities are frequently obligated to sell them, often at a discount.

For more on investment mandates, see "ACA-IAA Investment Management Compliance Testing Survey Covers Fees and Expenses, Investment Mandates, Big Data and Custody (Part One of Two)" (Aug. 2, 2018).

The result is that distressed investing requires a specialized fund with broad mandates allowing it to trade in:

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- distressed and out-of-favor credits, including commercial and corporate loans and asset-backed securities;
- residential sub-performing or non-performing loans and securities;
- corporate and commercial loans, mezzanine loans and other investments– including related warrants, options or other securities with equity characteristics – in subordinate levels of issuers' capital structures; and
- publicly traded or privately negotiated equity securities (*i.e.*, preferred stock, common stock and warrants) of stressed and distressed firms.

The distressed asset class has also become increasingly less liquid. Solus Alternative Asset Management was a victim of illiquidity, requiring it to restructure its $1.8-billion flagship hedge fund as liquidity in distressed assets dried up. Accordingly, any fund seeking to invest in distressed assets must have the ability to keep investor cash locked up to avoid redemptions that will require selling illiquid assets for less than their true value.

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