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Financial Statements

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Got My DIP Loan, so "Every Little Thing Gonna Be Alright!"[2]

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In a chapter 11 case, a debtor is typically focused on its own survival, which likely closely identifies with Billie Eilish's song "No Time to Die." In contrast, a lender's motivations for providing a debtor with debtor-in-possession (DIP) financing vary widely. Sometimes, the motivation is purely to earn interest and fees on the DIP loan itself, reminiscent of Pink Floyd's "Money." Other times, the DIP loan is considered a solution to a broader problem, reminiscent of Loretta Lynn's "I Pray My Way Out of Trouble," or a means to assert control over the case, reminding one of Johnny Cash's "King of the Hill."

The lender's motivations, along with many other factors, may have significant implications on the interest rate, fees and other terms of the DIP loan. As a result, the reasonableness of a DIP loan needs to be evaluated in the totality of the chapter 11 proceeding, including the DIP lender's relationship with the debtor.

Factors Driving Interest Rate and Terms of DIP Loans

Determining the appropriate interest rate and other terms of a DIP loan is a nuanced exercise. Restructuring practitioners need to consider the macroeconomic environment, the loan's size, the collateral's characteristics and many other risk factors, as investors generally demand higher returns for higher risks. The use of the bankruptcy court's powers to create administrative claims and employ super-priority repayment positions also greatly affects the risk profile of a DIP loan, thus influencing the pricing and terms of the loan. The interest rates and other terms of a DIP loan are driven by a variety of factors, such as the following:

- whether the DIP loan will be classified as an administrative expense and as a priority expense;
- the quantity and quality of the DIP loan's security interest;
- the repayment position (in particular, whether the DIP loan is a priming lien that precedes a significant financial investment);
- whether the collateral is easily marshalled and liquidated; and
- the likelihood of a timely and successful exit.

In addition, the vast majority of DIP lenders are already interested parties in the bankruptcy cases, typically creditors and equityholders rather than third parties.[3] When an "affiliated" lender offers a DIP loan, it is likely motivated not only by the interest and fees to be earned on the loan, but also by its existing and/or future stake in the debtor's business.

An existing creditor may seek to protect its pre-petition investment in the debtor's capital structure by refinancing the pre-petition debt with the DIP loan (commonly referred to as a "roll-up"). A stalking-horse bidder will likely be incentivized to provide DIP financing to keep the debtor afloat until the sale closes and to assert more control over the sale process. Given the prevalence of affiliated DIP lending, focusing solely on interest rates and fees when comparing one DIP transaction to another might be misleading.

1 The opinions expressed herein are those of the authors and do not necessarily reflect the views of their firms or clients. This article is for general information purposes and is not intended to be, and should not be, taken as legal advice. In addition, Mr. Mann and Mr. Lea are members of ABI's Board of Directors.

2 "Every Little Thing Gonna Be Alright!" is a well-known lyric from the song "Three Little Birds" by reggae artist Bob Marley.

3 According to *Debtwire*, in 2022, only $1.9 billion (or 21 percent) out of $9.4 billion in DIP financing and 16 (or 18 percent) out of 89 DIP facilities were provided by "true third-party lenders" that had "no meaningful connection to a debtor" apart from the DIP financing. Between 2016 and 2020, approximately half of DIP financings involved a roll-up component. *See* Catherine Corey & Qi Huang, "DIP Financing Report 2022," *Debtwire*, *available at* restructuringdata3.debtwire.com//article_assets/articledir_39589/19794891/dip%20financing%20report%202022%20publish_asset_6426e525c97c1.pdf (last visited on June 29, 2023).

According to *Debtwire*, 89 DIP facilities totaling more than $9.4 billion were made available to companies with $10 million or more of funded debt as of their bankruptcy filing in 2022.[4] Of the 89 DIP facilities, 44 were to "prime" companies (with at least $150 million of pre-petition funded debt), and 45 were to "middle-market" companies (with less than $150 million of pre-petition funded debt). The majority of the reported DIP loans were approved in the U.S. Bankruptcy Courts for the District of Delaware, Southern District of New York and Southern District of Texas, where larger bankruptcy cases tend to be filed. The volume of DIP loans to companies with less than $10 million of funded debt, which impact many restructuring practitioners, is also likely to be significant.

Debtwire reported that the interest rates on these prime and middle-market DIP loans varied from 3 percent to above 12 percent. In particular, 61 percent of the DIP loans had interest rates that were greater than or equal to 9 percent, and 24 percent of the DIP loans had interest rates greater than or equal to 12 percent.[5] The highest rates were found in the smallest DIP loans, although certain prime debtors also incurred high interest rates.[6] Furthermore, as the Federal Reserve has raised the target federal funds rate by 500 basis points since March 2022, interest rates on DIP loans are likely to be higher throughout 2023.

In addition to the interest rate, fees (such as commitment, backstop, monitoring and exit fees) are also key terms of a DIP loan and costs to the debtor. As with interest rates, reported fees also vary significantly, with 62 percent of the DIP loans reporting fees of less than 3 percent, while 16 percent reported fees greater than or equal to 12 percent. As a result, about half of the DIP loans covered in the *Debtwire* report had all-in costs (interest plus fees) that were greater than or equal to 12 percent.[7]

In practice, the authors' experience indicates that debtors smaller than those covered in the *Debtwire* report often experience even higher interest rates and fees. DIP loans in the lower-middle market can often carry all-in costs that are higher than 20 percent due to a lack of funding availability, limited lender competition in the space and the more significant impact of fees on the overall costs of smaller loans, among other factors.

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Understanding How Lender Motivations Impact DIP Loans

The wide variances in the interest rates and fees across DIP loans pose challenges for restructuring practitioners to determine the appropriate pricing for a DIP loan at hand. A simplistic view of taking the median or average interest rate and fees across historical DIP loans is likely insufficient. In fact, a DIP lender motivated by factors other than the return on the DIP loan (*e.g.*, shoring up an existing debt position or saving the debtor's business) might be more willing to accept more debtor-friendly terms on the DIP loan, including a lower interest rate and/or fees, compared to an otherwise similarly situated, disinterested third-party lender. As such, restructuring professionals need to seek a more complete understanding of the circumstances surrounding the transaction, and be aware that DIP lenders' motivations often affect the rates and terms of DIP loans available to a debtor.

To help practitioners evaluate the motivations of various types of DIP lenders and the role these motivations may play in negotiating the terms of a DIP loan, the exhibit illustrates a "DIP Loan *Billboard* Top 10" of DIP lenders' motivations in today's marketplace. As illustrated by this top 10 list, depending on a DIP lender's relationship with the debtor, its motivations for providing DIP loans vary, which has implications on the pricing and terms of the DIP loan.

If you are practicing somewhere other than Delaware, New York or Texas, you may be wondering whether these songs (and the information from *Debtwire*'s report) apply in your district. The number of zeros in the loans may be different, but the tunes should sound familiar. Let's consider a recent smaller case whose baseline sounds very much like a mashup of hits Nos. 4, 5 and 7 in the exhibit.

FKB LLC[8] is a subchapter V case from the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. The debtor, which sought a DIP loan of greater than $500,000, is a designer and developer of civic places, entertainment facilities and stages for musical acts, among other things. It had a complex capital stack for a small company, with six secured creditors holding perfected liens on a very limited pool of assets. The debtor had recently sold its receivables to a merchant cash-advance lender, and it had several unsecured loans. So, what could FKB possibly offer to a DIP lender? Here is what they brought to the table: (1) a first lien on approximately $350,000 of unencumbered accounts receivable; (2) a second position, subordinate to the existing secured lenders, on certain equipment that had negligible equity value; and (3) its intellectual property, largely consisting of the know-how of the designers, master welders, photographers and other craftsmen who work for the company, which made it extremely difficult to monetize.

4 *See* "DIP Financing Report 2022," *supra* at p. 3. The vast majority of the DIP facilities covered by the *Debtwire* report were term loans and revolvers, though there were bonds/notes and "other" instruments. In this article, "DIP loans" is used interchangeably with "DIP facilities" and as an umbrella term, without distinguishing the specific types of instruments.

5 *See* "DIP Financing Report 2022," *supra* at p. 6.

6 For example, DIP loans to OSG Group Holdings Inc. and Phoenix Services International LLC were at SOFR + 12 percent.

7 Debtwire also notes that "a number of DIP financing fees are sealed or undisclosed, which likely skews the number of DIP loans with lower all-in costs (including in some of the larger, higher-profile cases)." "DIP Financing Report 2022," *supra* at p. 6.

8 *In re FKB LLC*, 2:23-BK-11371 (Bankr. E.D. Pa.).

Exhibit

THE DIP Loan Billboard TOP 10

Rank	Title (Artist & Top Lyrics)	Producer (DIP Lender)	DIP Lender Motivation: Sustain Operations	DIP Lender Motivation: Control Process and/or Outcome	DIP Lender Motivation: Minimize Lender Losses	DIP Lender Motivation: DIP Loan Profitability	DIP Lender Motivation: Overall Lender Profit
1	**I Will Survive**	**Affiliate/Related Entity**	♫	♫			
	"At first I was afraid, I was petrified. Kept thinking I could never live without you by my side." — Gloria Gaynor		Related party support with debtor-friendly terms and pricing.				
2	**Beautiful**	**Management**	♫	♫			
	"You are beautiful, no matter what they say." — Christina Aguilera		To acquire the business with debtor-friendly terms and pricing.				
3	**Stand by Me**	**Equityholder**	♫	♫			
	"When the night has come and the land is dark … I won't be afraid.... Just as long as you stand by me." — Ben E. King		To save the business with debtor-friendly terms and pricing.				
4	**Beautiful Day**	**Existing Lender**	♫	♫	♫		♫
	"It's a beautiful day.... Don't let it get away." — U2		Enhance control and/or recovery with lender-friendly terms and market pricing.				
5	**I Hate Myself for Loving You**	**Vendor/Customer**	♫	♫			
	"I hate myself for loving you. Can't break free from the things that you do." — Joan Jett		Shield revenues or supply chain with debtor-friendly terms and pricing.				
6	**Mack the Knife**	**Loan-to-Own Credit Bidder**	♫	♫			
	"Oh, the shark, babe, has such teeth, dear." — Bobby Darin		Uses pre-petition loan and DIP to enhance control with lender-friendly terms and market pricing.				
7	**Great Balls of Fire**	**Stalking-Horse Bidder**	♫	♫			
	"You're fine, so kind. Got to tell this world that you're mine, mine, mine, mine." — Jerry Lee Lewis		To purchase the business with lender-friendly terms and market pricing.				
8	**Someone Like You**	**Pre-Petition (Non-Lender) Creditor**	♫	♫		♫	
	"I remember you said sometimes it lasts in love, but sometimes it hurts instead." — Adele		To recover its funds in any way necessary with lender-friendly terms and pricing.				
9	**Money**	**Third-Party Lender**				♫	♫
	"Money. It's a gas. Grab that cash with both hands and make a stash." — Pink Floyd		**Profit with lender-friendly terms and pricing.**				
10	**Moneytalks**	**Government**		♫			
	"The claim is on you, the sights are on me. So, what do you do that's guaranteed?" — AC/DC		In the public's best interest with debtor-friendly terms and pricing.				

Who would lend $500,000 against $350,000 of accounts receivable? A stakeholder who has an interest in the debtor and therefore some of the motivations (apart from profiting from the loan) covered in the exhibit. In this case, it is someone who relies on the debtor for its own benefit, is willing to provide funding to enhance its control of the outcome of the bankruptcy, and/or wishes to preserve value and acquire the company.

One such party existed in this example: Hard Six LLC, an affiliate of Aardvark Event Logistics Inc., an existing lender (see song No. 4), a customer of the debtor (see song No. 5) and, perhaps as a result of being a customer, a proposed stalking-horse bidder (see song No. 7). Prior to FKB's filing, Hard Six had loaned $500,000 to keep FKB operating and preserve its value. To sustain the debtor through a sale, Hard Six provided an $800,000 DIP facility, which included up to $550,000 of cash, plus an origination fee, an initial expense retainer, any reasonable fees related to the DIP loan post-petition, and a carve-out to cover certain costs of the debtor's financial advisor and counsel. This loan was proposed and approved by the court at an interest rate of 10 percent per annum.

The debtor's financial advisor was asked to test the market and determine whether a better deal existed for the debtor (it did not). It made sense that Hard Six would be willing to make a loan to this debtor with a relatively low interest rate. Hard Six wanted to preserve the going concern that it was trying to acquire, protect its interests as a customer and protect some of its pre-petition loan. In addition to allowing this new loan to prime existing financing and obtain a super-priority position on its administrative claims, the court order approving the DIP loan also approved the roll-up of $250,000 of Hard Six's pre-petition unsecured loan into the DIP loan, enabled the DIP lender to stipulate mileposts for the sale process (including a relatively quick closing date for the sale), and provided the DIP lender with reporting rights, broad releases and other benefits. These terms represented benefits to the DIP lender in addition to interests and fees, and were consistent with Hard Six's multi-layered motivations as a creditor, a customer, and a proposed stalking-horse bidder.

As the *Debtwire* report and this example demonstrate, depending on a lender's motivations for providing a DIP loan, nonfinancial terms are an integral part of a DIP transaction and may have significant value to a DIP lender. When evaluating past DIP-lending transactions, a debtor or prospective lender can benefit greatly from understanding the motivations of those DIP lenders in order to gain the insight necessary to make a valid comparison and negotiate in their best interest.

Now, we leave you with one last motivational DIP loan hit by The Beatles:

The best things in life are free / But you can keep them for the birds and bees
Now give me money / That's what I want. abi

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