Debtor-in-Possession Financing Facility (DIPFF) Proposal

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The US is facing a recession in which corporate cash flow is collapsing while credit spreads on corporate debt are surging. Yet, in significant ways, the current situation is markedly different than a typical recession. While in a typical recession, cash flows may experience a decline of, say, 10%, in the current COVID recession, cash flows for some firms will temporarily fall by 100%. Importantly, there are a large number of firms for which the current situation should be viewed as a pause: cash flows of many of the affected firms will bounce back once the COVID-recession is past. However, before the pause is over, firms may face situations where they are unable to service their debts and other fixed financial commitments. These sudden but temporary cash flow stoppages may force many corporations to file for Chapter 11 bankruptcy. But bankruptcy can lead to inefficient liquidation, a deadweight cost to the economy, which policy should aim to minimize.

The Fed has rolled out a number of new lending facilities that support the flow of credit to businesses. These measures include new funding facilities for commercial paper as well as for debt issuances in both the primary and secondary markets. Such facilities all aim to inject government risk-bearing capacity into the corporate bond market and thus reduce risk premia and bond yields.

While these programs aim in the right direction towards stabilizing the macroeconomy, their benefits will be diffused. The largest macro benefit of the Fed programs is to reduce the cost of borrowing and thus stave off bankruptcy. If, for example, Fed policy lowers the cost of rolling over debt from 10% to 5%, some corporate cash will be conserved. This savings may be enough to save some firms who are close to default. But importantly, the macro benefit is limited to avoiding deadweight costs of bankruptcy for these “at the margin” firms. Necessarily, the totality of these benefits will be small, because they apply to a set of firms much smaller than the universe of all firms.

We describe a more targeted approach to using the government’s risk bearing capacity to mitigate deadweight costs of bankruptcy. The goal is not to stop Chapter 11 restructurings from occurring, but rather to limit their deadweight costs when they do

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occur. There are two deadweight costs associated with bankruptcy: (i) inefficient liquidation of economically viable firms; and (ii) inefficient continuation of firms whose business models may be permanently unprofitable. For firms affected by the economic pause, concern (i) is likely to be much more significant than (ii). Our policy therefore aims to minimize inefficient liquidations (while remaining mindful of (ii)).

Upon a Chapter 11 filing, an automatic stay comes into immediate effect, and current management becomes the debtor-in-possession controlling the firm. The firm can continue operations while the bankruptcy process determines whether the firm should remain a going concern or be liquidated. The challenge arises if the firm needs external funding to continue. In the current environment of low private risk bearing capacity, the societal concern is that a debtor-in-possession’s cost of capital will be too high, leading to inefficient liquidation and negative externalities of liquidation on employees as well as upstream/downstream firms.

We therefore propose a debtor-in-possession financing facility (DIPFF) under which the government would offer DIP financing at an interest rate equal to the Federal Reserve Discount Rate (currently zero). DIP financing is senior to all other pre-bankruptcy unsecured claims. We would further propose that DIPFF loans be fully collateralized by the firm, when the firm has sufficient unencumbered collateral. If the firm’s collateral is already fully encumbered, then the facility could not lend unless the Bankruptcy court allows the DIPFF loan to be a priming lien, ensuring that the DIPFF loan is senior or equal to liens already attached to the firm’s collateral as necessary to ensure that the DIPFF loan is fully secured. The Federal Reserve will finance X% of a special purpose vehicle (SPV) that will own the DIP financing loans, across all corporations in default and applying to the facility. The Treasury will make an equity investment of 1-X% in the SPV. The underlying firm collateral together with the first-loss piece provided by Treasury will ensure that the Fed’s investment is risk-free.

The facility will have a limited term. It will be in force until the President declares the end of the formal Emergency declaration, thus capping the length of time of any induced inefficient continuation, while also being long enough to avoid the negative externalities of a bankruptcy filing on employees and other stakeholders through discontinued operations. Financing should be structured to cover only anticipated operating costs over the term. The goal of the program would be to supply ample capital for firms at a low rate to survive through the pause period. At the conclusion of the term, many firms would hopefully return to economic viability, repaying DIP financing and emerging from bankruptcy. Alternatively, those firms facing longer-term challenges post-crisis would continue through normal bankruptcy proceedings.
Addendum on Implementation

Because Section 13.3 of the Federal Reserve Act restricts the government’s ability to lend to insolvent entities, it may not be possible to lend directly to the firm through a DIP loan. Here, we discuss an alternative implementation, a Bankruptcy Protection Financing Facility (BPFF), that will provide needed capital while protecting the government’s interests.

To illustrate, we use the example of an automobile parts supplier (“Firm A”) whose revenues have collapsed to zero and will remain at zero for one year, at which point the health emergency is assumed to be past. The firm has operating costs of $15 for the year and debt outstanding of $100 with interest rate 10%.

The enterprise value of the firm is $100. This value is based on a forecast of revenues renormalizing after the health emergency is past.

The firm does not have cash to cover its interest expense and operating costs and files for Chapter 11 Bankruptcy. Note that for this firm refinancing the loan from 10% to 5% will not stave off bankruptcy. Moreover, the firm does not have sufficient assets to obtain $10 of loans from new creditors. Thus the Fed’s existing facilities will not help the firm avoid bankruptcy.

We propose that Firm A files for bankruptcy with the following reorganization plan in place and approved by the Bankruptcy judge and the BPFF. With limited exceptions, all of the assets of the firm are transferred to a wholly owned subsidiary of Firm A, “Sub B.” Sub B owns any property, plant, equipment, patents, etc., required to continue to operate the firm. Sub B also retains the management and other employees required to operate the firm. Certain contracts including pension obligations, trade credit, and collateralized liabilities are also transferred to Sub B. The parent Firm A would now be a holding company, retaining its existing equity and other debt claims, with the prior assets replaced by holdings of shares of Sub B. Thus, the economic position of Firm A’s creditors has not been altered.

As a result of this restructuring, the new subsidiary, Sub B, is a solvent entity eligible to receive BPFF funding. The parent, Firm A, remains in receivership. Sub B is controlled by a board of directors chosen by the creditors of Firm A, who are the effective owners of Firm A, and approved by the Bankruptcy Judge.
To fund its operating costs, Firm B receives capital from the government through the BPFF. We propose that these loans be made at a rate equal to the Federal Reserve’s discount window rate (currently equal to zero). Thus, in the example, over the course of the year the firm receives a loan of $15 from the BPFF to cover its operating costs.

In this example, if the health crisis passes as forecast and the firm’s going concern value is $100, this value can be used to first repay the government’s loan. The government is the senior creditor of Sub B. Sub B can secure a new loan from private lenders of $15 to repay the government loan, or if it operates in a manner that generates $15 of earnings, it can use this cash flow to repay the government. The government only suffers losses if Sub B’s going concern value is less than $15, which is the amount of cash required to operate the firm for the year. Through the bankruptcy process, the debt of Firm A is restructured. In the example, Firm A’s debt may be written down to $50. Firm A exits bankruptcy as the parent of Sub B, and the combined entity has debt of $65, the sum of the BPFF loan and the pre-bankruptcy debt, and enterprise value of $100. Sub B is a bridge company that enables the firm to survive the recession period of low cash flows.

If Sub B’s business is deemed to not be viable post-health crisis, then Sub B defaults on the government loans and also enters bankruptcy. At this point, the firm enters liquidation.

The terms of the BPFF facility will include a detailed “template” that specifies which claims are assigned to the bridge company and which to the parent. Only contracts necessary for the continued operation of the firm will be assigned to Sub B. These may include contracts with a union, pension obligations, any equipment leases, and trade credit. All other claims, including shareholders’ equity, senior unsecured debt, and other subordinate debt will remain in the parent.

A firm that chooses to file for bankruptcy and apply to the BPFF must file with a plan that specifies the assignment of claims. While the details will vary from case-to-case, we expect that the template will provide sufficient uniformity that the Bankruptcy Judge will be able to approve a plan expediently and enable the operation of the bridge company in a matter of weeks.

The BPFF will offer attractive terms on its loan, below that which would be obtained under a conventional private DIP financing. The goal of this subsidized lending is to
ensure that firms opt-in to this facility, and that the Bankruptcy judge recognizes that the enterprise value of the firm is maximized under a reorganization that is facilitated by the BPFF.

There are two alternatives for the financing structure of the BPFF.

In a government-only structure, the loans made by the BPFF will be held in special purpose vehicle (SPV). The U.S. Treasury and the Federal Reserve each provide a portion of the capital for these loans. As with other emergency facilities the government currently operates, the Treasury will own the equity first-loss piece and the Fed’s loans will be made against the collateral of the loans held by the facility. We approximate that the facility will make total loans of up to $500 billion, with the Federal Reserve funding $400 billion and the Treasury funding $100 billion, but the exact numbers will require careful analysis by the government.

In a private-government structure, eligible private lenders will make the loans to the bridge company and retain a portion of each eligible loan. The government SPV will purchase the remaining portion of each eligible loan. The Treasury will own the equity first-loss piece and the Fed’s loans will be made against the collateral of the loans held by the facility. This structure parallels that of the Main Street Lending Program. The price terms of the loans must be set in a manner that ensures that the BP loans are offered at an attractive interest rate. Again, these exact details will require careful analysis by the government.

Finally, we note that this implementation involving a parent company and bridge company resembles the single-point-of-entry (SPOE) resolution procedure for large banks. There is existing expertise in the financial and legal community on SPOE that can be leveraged to ensure implementability.
1. **For which types of firms are the DIPFF and BPFF facility intended?**

The facilities are designed for large corporations, such as automakers, airlines, etc., that will file for Chapter 11 in the event of distress. For example, the airlines have filed and emerged from Chapter 11 multiple times over the last few decades. While historically Chapter 11 filings have been too costly for small or medium-sized businesses, the Small Business Reorganization Act passed in 2019 allows these firms a less-costly version of Chapter 11. The facilities possibly with modifications, may also be made available to these firms.

2. **Why is the facility offered at a below-market interest rate?**

Absent this facility, firms that file for Chapter 11 will likely receive DIP financing from the senior creditor at a rate substantially higher than the discount window rate. Thus, there is a substantial subsidy implicit in our proposal. Such a subsidy is intended to dissuade the firm from turning to the senior creditor for DIP financing in order to forestall a set of inefficient actions that might be undertaken in that case. For example, the senior creditor may wish to liquidate assets to increase the value of its senior claim even if such actions destroy the potential value of the firm as an ongoing enterprise.

Likewise, in many cases bankruptcy allows the firm to offload their unfunded pension liabilities to the federal government through a distress termination with the Pension Benefit Guaranty Corporation (PBGC). In exchange for receiving attractive funding through the DIPFF or BPFF, the government may restrict such transfers.

3. **There is ample evidence that “credit easing” in the last crisis, via MBS purchases, had beneficial effects. Why do you posit that corporate bond purchases, which is also credit easing, will have small effects?**

The Fed's MBS purchases reduced primary mortgage rates. As a result, households were able to refinance mortgages to lower their monthly payments.
This effect was particularly important when coupled with the Home Affordable Refinance Program (HARP) in order to stabilize the balance sheets of liquidity constrained households, i.e., households that were underwater on mortgages and faced reduced income. These liquidity constrained households were able to reduce monthly payments, which allowed them to expand consumption and avoid foreclosure, generating beneficial macro spillover effects.

Contrast the target of these programs, liquidity constrained households, with the target of the corporate bond programs described so far, which are investment-grade (IG) corporates.

The latter are large corporations that regularly tap debt and equity markets. It is important to note that credit is currently flowing in debt markets, albeit at a higher than normal cost of borrowing. The Fed’s corporate bond facilities purchase up to 10% of a bond issue, indicating that private capital is available for the remaining 90%.

Given the economic “pause,” some amount of downscaling will be optimal. By lowering the interest rate at which the IG firm issues corporate bonds, the firm is able to reduce debt service costs and be left with more cash-on-hand. Money is fungible, so if it is optimal to downscale, the firm will downscale, and use the saved cash to pad future profits. As a result, the primary beneficiaries of the program are the equity holders of that firm, who can now expect a higher future dividend payment.

The key point here is the extent of macro benefit depends on the extent of liquidity constraints of the targeted firm. The underwater household is liquidity constrained to a far greater degree than the investment-grade corporate. For a hypothetical unconstrained corporate, the bond purchase is a pure transfer to existing equity holders. The Fed purchases induce the firm to adjust its financing decisions with no effect on its real decisions. Of course the latter is the object of interest for the macroeconomy.

4. If the government needs to prioritize where to place resources to support corporations, why is this program the right one?

If the government has limited fiscal resources that it wants to deploy efficiently, there is a clear pecking order: these resources should be directed first at the most constrained firms.
The facilities we propose rely on the Chapter 11 filing to reveal which firms are the most liquidity constrained. Since a Chapter 11 filing is costly, only the firm that needs the cash available at the facility to maintain its going concern value will file for bankruptcy.

Once fiscal resources are allocated to these firms, it may be optimal to target additional resources at other firms. But again as noted it is likely that since only some of the other firms, including high-yield and investment-grade, will be liquidity constrained, in many cases the fiscal resources will end up being a transfer to the equity-owners of these firms. To reiterate the point made in our proposal, the benefits will be diffused.

5. Why not instead have the government guarantee a private DIP loan?

This option, similar in spirit to the DIPFF, can help with some of the problems we identify. The loan guarantee helps to reduce the risk premium that private lenders will charge on the DIP loan, given the uncertainty in the market.

There are other concerns. First, the offered private rate may not be driven down to as low a rate as would prevail under the DIPFF. The DIP lender typically has some monopoly power in setting the loan rate (see link) that will lead to a loan spread. Second, the loan guarantee scheme will suffer the liquidation bias of private lending. Private DIP lenders are typically one of the senior creditors of the firms. These lenders will have an incentive to exert control and liquidate assets in order to shore up the value of their existing claims. Last, the bankruptcy court will take longer to scrutinize and approve a filing with a private DIP financier compared to the DIPFF. Thus the loan guarantee will not work as well to flatten the bankruptcy curve.

6. How will the size of the loan be determined?

In the government-only structure, the BPFF and DIPFF should contract with external underwriters who can assess and value the firm’s available collateral. The amount of funding should not exceed the collateral value or the firm’s anticipated operating needs over the loan term, whichever is smaller. To align incentives of the underwriter, underwriting fees may be made contingent on the performance of the loan.
In the private-government structure as outlined under the BPFF, the Eligible Lenders will retain a piece of the loan. Their “skin-in-the-game” can help to align incentives to size the loan.

The fractions of financing provided by the Eligible Lender, Federal Reserve and the Treasury must be chosen based on the risk of the underlying DIP loan portfolio. In principle, these fractions could depend on the underlying characteristics of the firm or industry in which the firm operates in a similar manner that haircuts at the Discount Window vary across types of collateral.

7. *Does the proposal run the risk that the Fed ends-up owning some real assets (e.g., a shopping mall)?*

This is a risk, albeit small in our estimation. The DIP lender is a senior creditor, thus will be repaid first before the firm exits Chapter 11. We envision that in almost all cases, the going concern value of the firm will exceed its cash needs during bankruptcy, so that the Fed’s loan is less than the going concern value. As a result, the Fed will be repaid with a very high likelihood. Additionally, the equity from the Treasury is a first-loss piece which further protects the Fed’s loan.

8. *Does the proposal run the risk that the Fed will be a DIP financier indefinitely? That is, could the Fed be part of a Chapter 11 process that stretches many years?*

The terms of the DIPFF and BPFF will specify a maximum term of the loans. For example, the facility can specify that the loans have to be repaid by the later of 9 months or the end of the emergency period as designated by the President.

9. *Will not the bankruptcy process become congested under this proposal?*

Upon a chapter 11 filing, the bankruptcy judge issues an automatic stay. This is the first and most critical step in the process. This step is also fairly easy and will not unduly burden the courts.

The second step in our BPFF proposal requires the judge to approve the plan
that transfers assets and liabilities from the parent company to the bridge company. While the details will vary from case-to-case, we expect that the existence of a standardized template will provide sufficient uniformity that the Bankruptcy Judge will be able to approve a plan expeditiously and enable the operation of the bridge company in a matter of weeks.

The last and most challenging step is the determination via the courts of the appropriate course of action for the firm. The DIPFF and BPFF buys time in the system, by allowing the firm to remain operating for an additional 6-9 months. During this time, the optimal scale and financial structure of the successor firm is likely to become apparent.

That said, because firms will only start defaulting once their equity value gets near zero, it may take some time before the pace of defaults accelerates. But it could then accelerate quickly. The administrative infrastructure for the bankruptcy facility should therefore be scaled up in preparation, including possibly the provision of additional resources to federal bankruptcy courts for the retaining of additional bankruptcy experts.

Finally, we note that without a DIPFF or BPFF, a wave of defaults will almost surely overwhelm the bankruptcy courts. The facilities we propose buys time and allows courts to delay and spread out the more complicated parts of the resolution process. Thus, relative to the alternative, these facilities will reduce congestion in the bankruptcy court system.