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, 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 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. In an economic pause, concern (i) is

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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.

Further Questions and Answers are at this Web Link
1. *For which types of firms is the DIPFF facility intended?*

The DIPFF is 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.

SMEs typically file for Chapter 7 liquidation. This facility will not avoid deadweight costs of bankruptcy for SMEs.

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, 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 DIPFF facility relies 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 DIPFF 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. **How will the size of the loan be determined?**

The 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.)

6. **What determines “X”?**

X is the fraction of financing provided by the Federal Reserve. It will depend on the risk of the underlying DIP loan. In principle, X 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. **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 more challenging step is the determination via the courts of the appropriate course of action for the firm. The DIPFF 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 DIPFF 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.