



Hedge Fund Returns

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We provide seamless service and unparalleled transactional advice to hedge fund managers. Our hedge fund manager clients benefit from our substantial expertise and reputation in fund formation, mergers & acquisitions, leveraged finance, real estate and structured finance transactions as well as our pre-eminent restructuring practice.

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The members of our hedge fund practice group are listed on the last page of this publication.

Are DIP Loans Worth the Investment?

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Introduction

A debtor-in-possession loan (commonly referred to as a "DIP" loan) is a loan extended to a company in chapter 11. Obtaining a DIP loan (or getting the court's permission to use cash collateral pledged to existing lenders) is an essential first step to enable the reorganizing company to continue its operations. As the default rate for leveraged loans continues to increase (with the March 31, 2009 S&P/LSTA Leveraged Loan Index at a record 8.02% by amount outstanding), DIP loans have been attracting a great deal of attention, both among companies contemplating commencing chapter 11 cases and investors looking for opportunities to employ capital. At the same time, many "traditional" sources of DIP capital have announced that they are reducing exposure to, or exiting entirely from, the DIP market. This lack of liquidity has increased yields on DIP loans to historic highs and made DIP loans attractive investments from a purely economic perspective. But do DIP loans provide opportunities for hedge funds and other non-incumbent investors, and are they worth the risk?

Priming Issues — a Barrier to Entry?

One immediate hurdle for hedge funds considering DIP investments is the company's pre-petition debt, which for highly-levered companies is likely to be secured by the vast majority of the company's US assets, and often two-thirds of the stock of any first-tier foreign subsidiaries. Although the United States Bankruptcy Code authorizes a company in chapter 11 reorganization that is otherwise unable to obtain post-petition financing to obtain an unsecured DIP loan with "superpriority" administrative expense status — an elevated status that requires that the DIP lender's claims be paid in full in cash ahead of other post-petition administrative expense claims (and before any distribution to creditors under a plan of reorganization) — in practice very few lenders will consider extending credit on an unsecured basis. A DIP lender will therefore have to consider extending credit on a junior or partially-secured basis — unlikely in most cases except where there is a large pool of unencumbered collateral — or the DIP loan will have to be structured in a way that "primes" existing liens.

Non-consensual priming is very difficult to achieve except in situations where the existing secured creditors are "adequately protected" against diminution in value of their collateral, usually through payments of post-petition interest or the granting of replacement liens. However, adequate protection is generally not available where the value of the collateral is less than the amount of the pre-petition secured

debt claims. Therefore, in cases where there is not enough of an equity cushion to provide pre-petition secured creditors with adequate protection (so that the priming is consensual), there is effectively a barrier to entry for new lenders, who are unlikely to want to engage, via the debtor, in a time-consuming and expensive “priming fight” with pre-petition secured lenders (with no guarantee of success).

The difficulties in priming existing secured lenders, coupled with the need for the company in reorganization to obtain additional funds, often result in incumbent lenders providing the DIP loan (so-called “defensive DIPs”) and effectively priming themselves. In the first quarter of 2009, an estimated \$11 billion of DIP loans (including *LyondellBasell*'s \$8 billion DIP loan) were arranged, of which only a small portion were non-defensive, new money DIPs.

Advantages of DIP Investments for Hedge Funds

Where there is enough new collateral to support the DIP loan, or where hedge funds are considering participation in a defensive DIP or adopting a “loan-to own” strategy, a DIP investment may be an attractive investment opportunity for the following reasons:

- **High Returns:** The scarcity of financing in the current marketplace coupled with a reduced appetite for risk have caused yields on DIP loans to skyrocket.
- **Bankruptcy Code Protection:** A DIP loan has long been considered a relatively safe investment because of the protections that the Bankruptcy Code provides, both in terms of priority, liens and the requirement to be paid in full in cash before a plan of reorganization can become effective.

- **Short Investment Horizon:** Many recent DIP loans have 6 to 12 months' maturity. Short maturities create additional fee-earning opportunities in the event that the lenders agree to a term extension or other amendments.

Whether looking for high returns on a debt investment or pursuing a “loan to own” strategy, hedge funds may find the current gap in the DIP loan market to be an excellent opportunity.

- **Hedge Funds as Preferred Lending Source:** Many hedge funds have a ready pool of cash that can be mobilized quickly and is not conditioned upon effective syndication. In addition, subject to their investment goals and governance documents, hedge funds may be amenable to exploring creative capital solutions — such as agreeing upfront to convert DIP claims to equity — that traditional DIP providers may not be willing or able to accommodate.
- **DIP Loans as Fulcrum Security:** One of the unintended consequences of highly-levered debtors with complex debt structures is that the company's “fulcrum security” (the debt instrument most likely to convert into equity on a plan of reorganization) has shifted toward first lien debt or even to DIP loans (such fulcrum security has traditionally been lower in the company's capital structure). Hedge funds pursuing a “loan-to-own” strategy may therefore consider an investment in DIP loans even if they are not existing investors, or may purchase a block of first lien debt

at a discount in order to control a majority or blocking position that can influence the outcome of a plan of reorganization.

- **Information Advantage:** Through reporting covenants in the DIP loan documentation, a DIP loan investment provides lenders who are willing to be restricted (or “private-side”) with the ability to gain direct access to valuable information about the company that is not otherwise publicly available.
- **Expedited Process:** The DIP loan documentation may provide for certain milestones (e.g., sale deadlines), which will expedite the reorganization process by forcing the company to take specified actions to avoid an event of default.

Risks and Other Considerations

As with all attractive investment opportunities, DIP loans come with several risk factors. In light of the current state of the DIP loan market, hedge funds may find it prudent to consider the following:

- **Contentious Bankruptcy Process:** The large number of participants in a company's senior secured debt tranches, plus the ability of non-controlling or minority holders to withhold consent (particularly under pre-petition credit documents), has complicated every bankruptcy case. Moreover, the interests of distressed debt funds (which may include the trading desks of the very same hedge funds considering the DIP investment) may not be aligned with those adopting a longer-term investment strategy.
- **Roll-ups and Inter-Lender Litigation:** Non-pro-rata roll-ups — whereby only those pre-petition lenders that participate in a new money DIP financing are able to convert a corresponding portion

of their existing secured loans to post-petition claims — are a recent but increasingly common financing structure. These roll-ups may violate the pre-petition credit agreement (including the pro rata sharing provisions that often require 100% vote to amend) and may expose those lenders participating in the roll-up to inter-lender litigation.

- **Conversion to Exit:** Because of the current lack of financing sources, before committing to a DIP financing, hedge funds should strongly consider the availability (or lack thereof) of exit financing or be prepared to provide it themselves. Such exit financing is usually essential to the company's emergence. In the recent *Buffets* chapter 11 case, the lack of exit financing has resulted in DIP lenders being asked to contribute new money to the exit facility and in return, such DIP lenders being

permitted to “roll” their DIP loans into a new second lien exit facility.

- **Early Involvement:** The early-warning triggers in most senior credit agreements (such as financial covenants) mean that incumbent pre-petition lenders have advance notice of a company's difficulties and may organize themselves early. In order to better influence the process, hedge funds considering DIP loans should consider early involvement in the pre-petition debt through distressed market purchases. Moreover, many of the defensive DIPs have been done on a pre-arranged basis, whereby constituent classes of creditors agree to treatment under a plan of reorganization before the bankruptcy case is filed, enabling a speedier reorganization. Therefore, once the company is in bankruptcy, it may be too late to take advantage of a valuable opportunity.

- **Internal Limitations:** A hedge fund needs to consult its counsel for restrictions in its governance documents. For example, some funds may restrict the ownership of equity securities received in a plan of reorganization.

Whether looking for high returns on debt investment or pursuing a “loan to own” strategy, hedge funds may find the current gap in the DIP loan market to be an excellent opportunity. DIP loans, by definition, are arranged for a company in or entering bankruptcy, but capitalizing on these opportunities may require participating in a company's existing debt and well in advance of the actual bankruptcy filing. Hedge funds are advised to carefully consider such opportunities in light of some of the legal and market risks outlined above.

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