Moody's Global
Corporate Finance

Special Comment

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Moody's Comments On Debtor-In-Possession Lending

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Overview

- Rising default rates on corporate debt are likely to increase the need for debtor-in-possession financing for large corporate entities in the coming months
- Historic default risk for DIP's has been quite low, and supports the market convention that risks in DIP lending may not be significant
- Yet recent trends in the marketplace could suggest that default risk for DIP lending could increase
- Because of the limited default history, it is difficult to accurately assess loss given default experience for DIP's. Anecdotal evidence suggests that with good collateral coverage defaulting DIP's should experience low losses
- Moody's has extensive experience in rating DIP facilities, primarily on a private unmonitored basis. Some more recent DIP ratings have been provided on a published, unmonitored basis.
- Moody's will soon publish a methodology for DIP ratings that will provide the market with greater transparency regarding the way in which DIP ratings are assessed.

Moody's Investors Service

Rising Default Rates Drive Growth in Debtor-in-Possession Lending

With the continued worsening credit crunch and weakening economic outlook, corporate credit quality is expected to show further weakness, and credit defaults and bankruptcy filings by rated issuers are expected to increase. Year to date, there have been 46 U.S. companies rated by Moody's that have defaulted on debt. The speculative grade default rate for U.S. issuers was at 3.3% in August, more than double the 1.4% rate this time last year. Moody's current outlook is that global speculative grade default rates will increase to about 4.9% by December 2008 and could increase further into 2009.

Several industry sectors have already shown this increasing risk; the homebuilding and building supply sectors have weakened materially following the mortgage crisis, the airline sector has radically weakened with several smaller airline bankruptcies on the heels of record high fuel costs, and restaurant companies have been impacted by a weak consumer environment and escalating operating costs. Going forward, other sectors will likely follow.

Moody's believes that rising defaults and bankruptcies will likely precipitate an increase in the need for Debtor-in Possession (DIP) lending arrangements. Already, for the first half of 2008 a number of new DIP facilities have been created for large North American companies that have entered bankruptcy, including Buffets, Inc.; Linens 'n Things, Inc.; Quebecor World, Inc.; and Wellman, Inc. The pace of activity has decidedly increased from 2007 and is expected to accelerate into 2009.

Larger Size and Broader Distribution Causing Greater Interest in Ratings for DIP's

Over the last several years Moody's has received increasing requests to assign ratings to DIP facilities, particularly for larger companies. We believe that several factors underlie the increasing requests: 1) the large size of many DIP facilities required by some bankrupt companies necessitates broader distribution, 2) more and different types of investors are attracted to the asset class because it offers high returns with potentially low risk, and 3) the participation of institutional investors in roll-over portions of DIP's (pre-petition debt that is rolled into the DIP facility).

Historically, DIP lending was largely carried out by commercial banks and specialized finance companies and usually involved moderate sized facilities, up to a few hundred million dollars. However, over the last several years many larger DIP facilities have been brought to market, including a $1.0 billion deal for Quebecor World, Inc. in 2008; a $1.75 billion deal for Dana Corp. in 2006 (since emerged from bankruptcy); and a $1.7 billion deal for Delta Air Lines in 2005 (since emerged from bankruptcy). While in some cases pre-petition secured lenders will become participants in DIP facilities, particularly when some portion of the pre-petition debt is rolled into the DIP, many traditional lenders do not focus on DIP lending as a core product. With the large size of many recent DIPs, distribution has increasingly involved non-traditional DIP lenders including institutional lenders, CLO's/CDO's, and hedge funds. In many cases, these non-traditional lenders have requested debt ratings for DIP facilities as part of their overall investment practice.

Over the last several years Moody's has assigned ratings to a significant number of DIP facilities, primarily on a point-in-time, private letter basis. In some cases, when issuers have requested, Moody's has assigned public, unmonitored ratings to DIP facilities. Following is a list of public, unmonitored DIP ratings assigned by Moody's during the last several years.

Public, Unmonitored DIP Ratings Assigned by Moody's

Company	Date Rated	Facility Description	Rating
R.J. Tower Corporation	4/6/2005	$300MM DIP Revolver	Ba2
(Emerged July 2007)		$425MM DIP TL	Ba3
Delphi Corporation	11/7/2005	$1.75 Billion DIP Revolver	B1
(Still in reorganization)		$250MM DIP TL	B1
Dana Corporation	3/28/2006	$750MM DIP Revolver	B3
(Emerged February 2008)		$700MM DIP TL	B3
Northwest Airlines, Inc (Emerged May 2007)	8/9/2006	$1.225 DIP Facility	Ba2
Dana Corporation	1/11/2007	$650MM DIP Revolver (Amended)	B1
(Emerged February 2008)		$900MM DIP TL (Amended)	B2
Quebecor World, Inc	2/11/2008	$400MM DIP Revolver	Ba2
(Still in reorganization)		$600MM DIP TL	Ba3
Buffet's Inc.	4/23/2008	$85MM New Money DIP TL	Ba3
(Still in reorganization)		$200MM Roll-over DIP TL	B3

Credit Risk of DIP's Compared to Pre-Petition Lending

Debtor-in-possession lending has historically been viewed as a relatively low risk investment, primarily because of the special status granted to DIP lenders by Section 364 of the U.S. bankruptcy code. The purpose of DIP financing is to provide a bankrupt company with funds necessary to operate its business while it is developing and implementing its plan of reorganization. Accordingly, DIP facilities must be approved by the bankruptcy court overseeing the reorganization. A critical consideration in any DIP transaction is determining whether or not the court has specifically approved the DIP status of the proposed facility. Once the DIP status has been approved by the court, the facility will enjoy a super-priority status in the liability waterfall; essentially at the time of winding-up of the bankruptcy case, either through emergence from bankruptcy or through liquidation of the company, DIP lenders are repaid in full before any distributions can be made to pre-petition creditors. In substantially all cases, DIP lenders are granted liens on the assets of the bankrupt company, in some cases ahead of the liens of pre-petition secured lenders (priming liens). Through the benefit of these liens on the company's assets and the superpriority status in the liability waterfall, DIP facilities are generally viewed to offer strong protection against loss.

DIP facilities may involve both "new money" and "rollover" portions. The new money portion refers to situations where new funds are made available to the company either under a new revolving credit facility or a funded term loan. The rollover portion of a DIP occurs when pre-petition secured borrowings of a company are rolled-over and made part of the DIP facility. This might occur when a company has already pledged all its available assets to pre-petition bank lenders. With court approval, priming liens can be granted to new DIP lenders on the collateral securing pre-petition debt. These priming liens have priority over the liens held by the pre-petition lenders, and are necessary to induce DIP lenders to extend new money loans to the company.

Moody's DIP Database

As part of its monitoring of the DIP lending market, Moody's has developed a database of DIP facilities created for large publicly registered companies that defaulted between 1988 and 2008. As of August 2008, the database includes information for 297 DIP facilities that have either been repaid and/or terminated and for which a final plan of reorganization approved by the bankruptcy court was available that defined distributions to pre-petition and post-petition lenders. In some cases the database includes recast DIP facilities for companies that increased an existing facility, renewed a maturing facility or substantially amended an existing facility. Some overview statistics about the DIP database are summarized below.

Average total commitment of the DIP facilities was $130 million, while the median commitment was $60 million

Distribution by Size:

Size	No. of DIP's	Size	No of Dip's
$1.0 Bio or larger	4	$50MM to $100MM	63
$500MM to $1.0 Bio	12	$25Mm to $ 50MM	67
$250MM to $500MM	27	$25MM or smaller	52
$100MM to $250MM	72	Total	297

Initial maturities were normally in the 18 month range

Over 21% of DIP's were never drawn

Average maximum utilization of DIP was 41% of total commitment

Default Risk of DIP's for Large Public Companies has Historically been Low

An assessment of the performance of individual DIP's supports market convention about the low risk of DIP lending. Moody's has studied the default and loss experience of facilities in its DIP database including 297 bankruptcy cases that were resolved, either through emergence or liquidation of the company, allowing an assessment to be made about the default probability of this group of DIP facilities. Of the 297 cases, only 2 DIP facilities experienced defaults involving missed payments of scheduled principal or interest---Marvel Entertainment Group failed to make timely repayment of its DIP loan at maturity in June 1997, and in 2001 Winstar Communications, Inc. was unable to fully repay its $175 million DIP facility. When analyzed on a monthly cohort basis this data suggests a default probability of about 0.5%. This relatively low default probability could be consistent with a low investment grade rating.

Summary Details of Defaulted DIP's

- **Marvel Entertainment Group:** filed for bankruptcy protection on 12/27/96 due to declining business prospects that could not support its debt load. Competing reorganization plans by two corporate investors (Perelman and Icahn) stalemated the process. The DIP was not repaid at its 6/30/97 scheduled maturity; lenders provided forbearance and received current interest and some principal reduction until the company emerged from bankruptcy on 10/1/88. The DIP was repaid in full, but not per original payment terms of the facility.
- **Winstar Communications:** filed for bankruptcy on 4/18/01 following a liquidity shortfall which the company attributed to a failure of Lucent Technologies to honor a contract agreement. Excess capacity and the crash of the telecom bubble weakened the value of the company's business, precluding a restructuring. The assets were sold in December 2001 for $38 million, implying a recovery in the 20-30% range.

With Limited Default History, Loss Given Default for DIP's is Difficult to Measure

The loss given default experience for the Marvel Entertainment and Winstar Communications DIP facilities were dramatically different, and makes a good assessment of loss given default for DIP's problematic. In the case of Marvel Entertainment the DIP facility was ultimately repaid in full; even considering any loss associated with time value of money recovery rates under the facility were extremely high. However, in the case of Winstar Communications, the company's assets were ultimately liquidated for proceeds of about $38 million, which in comparison to the size of the DIP suggests recovery rates in the 20-30% range. With only two noted cases of defaulted DIP's and such polar outcomes for the two cases, it is difficult to draw any reasonable conclusions about loss given default for DIP facilities.

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As an alternative approach, Moody's has attempted to gain some sense of risk by looking at the magnitude of excess coverage of DIP's at the time of a company's emergence from bankruptcy. Conceptually, at the time of emergence all DIP obligations are repaid before any distributions are made to pre-petition lenders. By observing the magnitude of distributions to pre-petition creditors in relation to the size of the DIP facility it is possible to estimate the asset value cushion (excess coverage or distance from loss) that a DIP facility would have enjoyed had it experienced a default. In doing this analysis, Moody's has made certain assumptions:

- At the time of emergence the full committed amount of a DIP facility is assumed to be outstanding, and is given first priority in repayment. This assumption likely results in a conservative outcome in our analysis as historically the average maximum utilization of all DIP facilities in our database was equal to about 41% of the committed amount (including revolvers and term loans). While covenants in DIP facilities would normally place constraints on revolver drawings if a company were not meeting certain thresholds associated with the reorganization, we have assumed, for conservative purposes, that the full amount of the committed facility is drawn.
- The excess recovery value is equal to the aggregate value available for distribution to pre-petition creditors in the bankruptcy court's final order approving the company's emergence from bankruptcy and after repayment of the face amount of the DIP facility. This recovery assessment excludes the value of any equity included in the distribution. This approach makes the analysis somewhat more conservative, but is taken in consideration of the belief that if a firm were to default on a DIP facility, the prospects of a failed reorganization and potential need to liquidate would likely cause its equity value to diminish.

Graph 1 depicts a curve that indicates the "distance from loss" for a subset of the 297 DIP's in the database; specifically for 188 DIP's created between 2000 and 2008 for which recovery data was available. The data is arrayed in ascending order of recovery, and demonstrates the range of recoveries from less than 1x in the case of Winstar Communications to over 8 times (note that about 30 cases involved recoveries over 8x, with the maximum coverage observed in one case of 70x). The cases that involve lower recoveries for pre-petition lenders would suggest a modest degree of protection or "distance from loss" if the DIP had actually experienced a loss. Many of the situations with high coverage levels involved relatively small DIP facilities ($50 million or less) for companies with much larger pre-petition liabilities for which some distribution was made at the time of emergence. An Example is Birmingham Steel Corporation, which on June 3, 2002 made a pre-packaged bankruptcy filing which contemplated the ultimate sale of substantially all of the company's assets to Nucor Corporation. As part of that filing Birmingham Steel arranged for a $40 million DIP facility. Birmingham's reported liabilities subject to compromise exceeded $500 million, and enjoyed substantial recovery under the pre-packaged bankruptcy filing. The small DIP size relative to the larger distribution to pre-petition creditors results in the very high coverage metrics.

Importantly, the data suggests that there are numerous cases where the margin of excess value distributed to pre-petition lenders is modest in relation to the DIP size. For instance in about 70 cases the value distributed to pre-petition lenders is 2x or less than the face amount of the DIP facility. While this magnitude of cushion might seem adequate, it should be considered that if the company's reorganization efforts had failed, the value of the assets would likely have fallen below that distributed at emergence. If this had happened, a drop of more than 50% in the value realized on the assets would likely have produced a loss for DIP investors. In light of the volatility of asset values of distressed companies, this margin of protection might not be significant.

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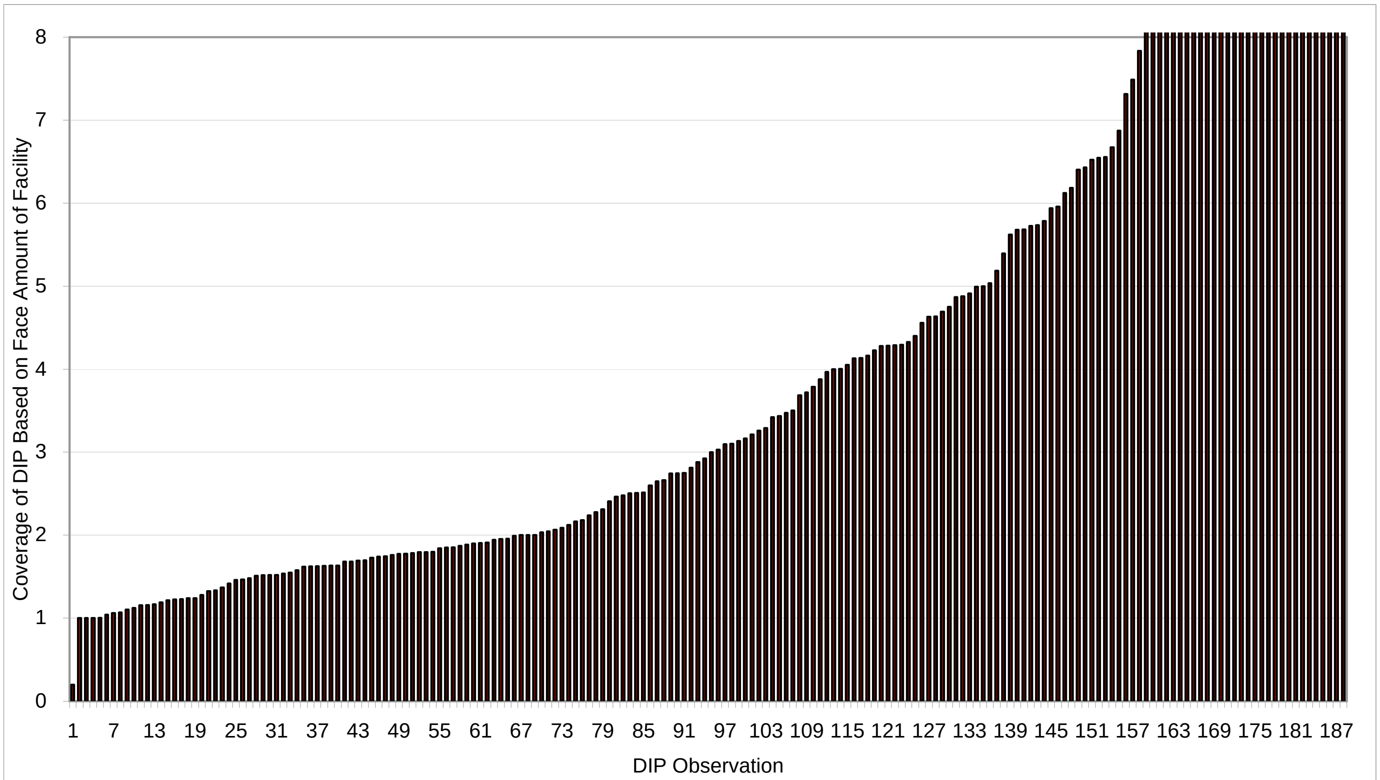
Graph 1

Asset Coverage of DIP Facilities (times covered)

(calculated as Value distributed to pre-petition lenders excluding equity instruments + DIP face amount) / DIP face amount)



Current Environment Could Suggest Higher Risk for DIP Lending

Past experience might not be an adequate reflection of future credit risk for DIP's. In the current environment, Moody's believes that it might be more difficult to successfully reorganize a bankrupt company in a timely fashion, and this could give rise to higher default risk for DIP's. This concern stems from changes in the bankruptcy law, changes in the make-up of pre-petition and post-petition debt investor bases of many companies, and the growing complexity of many bankruptcy cases. Moreover, in the current weak economic environment, asset value volatility poses a risk in ensuring adequate collateral coverage; the land holdings of a home builder might have been seen as offering good asset protection a few years ago might be of significantly less value today.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 included provisions that are designed to accelerate the reorganization process, but which could indirectly raise the risk of DIP defaults. Specifically, the act limits the bankruptcy court's ability to extend the period during which a bankrupt company has an exclusive right to file a plan of reorganization. Under the former law, the initial exclusivity period was 120 days, but was often the subject of repeated court extensions – sometimes for years on end. Under the revised law, a bankruptcy court may not extend a company's exclusive right to file a reorganization plan beyond 18 months from the date of bankruptcy filing. The new law permits competing plans of reorganization to be submitted if a company is unable to successfully reorganize during the initial 18 month period. This could increase the risk of timely repayment of DIP facilities that mature when any such competing plans are being contested. While the initial maturity dates of DIP facilities are generally set within the 18 month period of exclusivity, companies that require greater time to reorganize often seek DIP renewals or maturity extensions that can reach outside the exclusivity period. Depending on the particular situation of the company involved, the risk profile of a DIP facility for a company that has exceeded the exclusivity period could be elevated.

The nature of pre-petition and post-petition investors in corporate debt has evolved over time and increasingly includes non-traditional groups such as hedge-funds, distressed debt investors and other parties that might have different or competing objectives. In some cases, these competing investment objectives can complicate the reorganization process, extending the time needed to reorganize and exit from bankruptcy. As was the case with Marvel Entertainment, such a situation could result in the company being unable to meet a scheduled maturity of a DIP facility. While DIP lenders may ultimately achieve full recovery in these situations, the inability to make timely payments under the DIP is indicative of a higher level of risk.

Another factor that Moody's believes is increasing the risk of DIP lending in the current environment is the scope and complexity of the reorganization required for large corporate bankruptcies. In some cases the plan of reorganization not only looks at restructuring funded debt but also involves other liabilities such as unfunded pension obligations or product liability claims (asbestos for instance), or can involve significant changes to labor contracts, supplier agreements or other contractual arrangements. In these situations, the success of the plan or reorganization can often depend on reaching agreements with a broad range of parties, including lenders, suppliers, labor unions, the Pension Benefit Guarantee Corporation (PBGC), key customers, and other parties. The greater complexity of these cases can make it more difficult to reach agreement on a plan of reorganization that meets the needs of all claimants, and can increase the risk of DIP loans made to such companies. A good example of this risk is Delphi Corporation, which filed for bankruptcy protection on October 8, 2005. The company's reorganization has involved negotiations with numerous parties regarding complex issues related to employee benefits, customer supply agreements, and other issues, but has not yet enabled the company to emerge from Chapter 11 protection. The company's DIP facility has been renewed or extended on several occasions, but the current environment in the auto parts industry could make it difficult to achieve a successful reorganization before the scheduled maturity date.

Moody's practices in assigning DIP ratings

Moody's will make ratings available for DIP facilities only upon the request of the specific issuer and in accordance with our normal business practices. Important considerations in relation to DIP ratings include the following.

<u>Ratings are unmonitored:</u> To this point Moody's has only rated DIP facilities on an unmonitored basis, meaning that the rating is only valid as of the point in time when it is issued, and will not be monitored or updated on a go forward basis. The inability to assure that adequate information will be made available on a consistent and timely basis to facilitate monitoring of the rating is the principal reason for this practice.

<u>Ratings attend only to the specific DIP facility:</u> In rating DIP facilities Moody's only assigns a rating to the specific DIP instrument. We do not assign corporate family ratings as we would do with going concerns. This is because of the importance of the structural features of the DIP facility in determining the rating of the DIP. Ratings assigned to a DIP facility are only valid for that specific facility and can not be used to infer our opinion about the credit quality of other claims against the debtor-in-possession.

<u>Private or public ratings:</u> Moody's has primarily issued ratings for DIP facilities on a private letter basis. Private letter ratings relate only to the specific instrument being rated and are delivered to the company requesting the rating. The private letter may be shared with prospective investors in the DIP facility, but is not intended to be more broadly disseminated to other creditors. When requested, we have made public disclosures of DIP ratings via press release announcement. These announcements specifically state that the DIP rating is provided on a point-in-time basis and will not be monitored. Public ratings on DIP's have increasingly been requested as a means of expanding disclosure in relation to the broadening distribution of DIP facilities within the financial markets.

<u>DIP ratings in relation to Pre-petition and emergence ratings:</u> Moody's views the pre-petition, DIP, and emergence ratings of a company as independent assessments of credit quality reflective of the company's status and condition at different points in time. Moody's will not simultaneously maintain pre-petition and DIP ratings or DIP and emergence ratings on a company. Generally, ratings on pre-petition debt will be withdrawn

once default has occurred, cure periods have expired and/or a bankruptcy filing has been accepted by the courts. During the bankruptcy process, DIP ratings may be requested and will be provided on a point-in-time, unmonitored basis. When the company emerges from bankruptcy, new ratings reflective of the company's reorganized business profile, earnings and cash flow prospects and capital structure will be assigned.

The rating for a DIP facility will likely be higher in the rating scale than the corporate family rating assigned to the issuer pre-petition. Moody's seeks to manage its ratings such that the probability of default rating of an issuer that is approaching bankruptcy will be no higher than the Caa category during the year prior to default. Yet once the company is in default, the rating for the DIP facility no longer considers the risk associated with the pre-petition entity, but rather addresses the specific risk of the DIP facility. In that regard, and in recognition of the super priority status of DIP facilities and the historic evidence of relatively low default risk for DIP facilities, the rating assigned to a DIP facility is likely to be higher than the pre-petition corporate family or probability of default ratings of the issuer. In some cases, the rating of a well structured DIP could fall within the lower end of the investment grade category. Upon emergence, new ratings will be assigned to the company based upon its financial profile post-bankruptcy. The corporate family rating assigned at this time is likely to be lower than the rating of the DIP, but higher than the pre-petition CFR. The loss of the super priority status and the broader range of risks that the new going concern will be exposed to underlie this outcome.

DIP Rating Methodology to be Published

In recognition of the growing market interest in DIP ratings, Moody's is in the final stages of defining a rating methodology for Debtor-in-Possession loans, which it expects to publish in the next few months. The methodology will consider the historic default and loss experience of DIP facilities for large corporate entities as well as current market experience and developing trends which could influence future default and loss experience for DIP's. The methodology will place focus on the nature of a given company's bankruptcy reorganization and probability of successful emergence, the structural features of the DIP facility that could provide protection for investors if the reorganization should falter, and the adequacy of collateral protection for DIP lenders should the reorganization fail and the DIP facility experience a payment default.

Moody's Related Research

Special Comment:

- The Risk of Voluntary Strategic Bankruptcy: Implications for U.S. Corporate Bond Ratings (February 21, 2006) (96746)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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