Why the Feds Should Step Into Bankruptcy Loans

BANKRUPTCY, BAILOUT
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Massive layoffs. Liquidations. Rising unemployment. The destruction of the tax base of communities across the United States. A prolonged L-shaped recession or even depression. These are some of the potential disastrous scenarios that could arise if the large number of currently over-leveraged companies in distress cannot fix their operations and capital structures through chapter 11 due to a lack of financing.

Congress, recognizing the general wisdom that a company is more valuable operating than liquidating, established the Bankruptcy Code, which provides companies in distress with tools to fix their operations, right-size their balance sheets and divest themselves of assets, while being protected from actions of individual creditors. The Bankruptcy Code does not guarantee survival of companies in distress, but it provides the opportunity for companies to maximize value for the benefit of stakeholders and emerge from chapter 11 with a fresh start.

To operate in Chapter 11, a company needs liquidity. While the Bankruptcy Code provides protections and tools, it does not provide liquidity. The DIP loan -- i.e., the loan made to a distressed company to enter and operate in chapter 11 --provides liquidity and used to be a no-brainer for a company to obtain and a lender to make. DIP loans have special status under the Bankruptcy Code, providing protections to DIP lenders. However, today, the DIP loan market is severely constrained. For our corporate reorganization regime to work properly, distressed companies need access to the DIP loan market or good, but over-leveraged, companies will fail.

The Troubled Asset Relief Program (TARP) may help loosen up the credit markets. It is intended to encourage banks to begin lending again. TARP provides funds to banks, but it does not provide direct financial support to companies desperately seeking liquidity. As a result, although TARP may open the credit markets at some point, it will not work quickly enough to provide the necessary cash infusions to struggling companies with urgent financial needs.

To help distressed companies maximize value and preserve jobs, the DIP loan market needs to be opened. To do this, the government should take a page out of its playbook and promulgate a program similar to the loan guaranty program established for airlines shortly after September 11th. Specifically, the government should implement what I call the Distressed Company Loan Guaranty Program of 2008 (DCLGP) and guaranty DIP loans.

Here is how the DCLGP will work. Companies in distress will apply for DIP loan guarantees. To qualify, the distressed company will need to establish that (a) it has an urgent need for liquidity and, without it, the company may fail, thereby eliminating a significant number of jobs, (b) its going concern value is greater than its liquidation value, (c) it has a business plan to reduce its leverage and fix its operations, (d) it has sufficient assets to support the requested DIP loan and (e) it has DIP financing in place, subject to obtaining the guaranty. If the application is accepted, DIP loans provided to the qualifying distressed company will be guaranteed by the government. In exchange for this risk-free loan, DIP lenders will need to charge a “normalized market-based” rate -- e.g., LIBOR plus 2 percent. An additional premium will be added to the rate to compensate the government for the risk of the guarantee being called. Thus, the potential cost of the program will be offset by the premium paid to the government for the guarantee.

The DCLGP would allow distressed companies to obtain the financing they need to reorganize and survive. At the same time, the process, in general, will be conducted in the private sector, with distressed companies and DIP lenders negotiating the terms of the credit facility. The government guaranty will grease the DIP lending wheels, but will not leave taxpayers at risk because the government will be compensated for any risk in real time. As a result, the DCLGP will provide an environment for distressed companies to get the direct capital infusions they need to reorganize their operations and capital structure, thereby maximizing the value of their assets and preserving jobs.

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