BANKRUPTCY & COVID-19 WORKING GROUP

The Honorable Nancy Pelosi
Speaker
House of Representatives
1236 Longworth House Office Building
Washington, D.C. 20151

The Honorable Mitch McConnell
Senate Majority Leader
United States Senate
317 Russell Senate Office Building
Washington, D.C. 20510

The Honorable Kevin McCarthy
House Minority Leader
House of Representatives
2468 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Charles Schumer
Senate Minority Leader
United States Senate
322 Hart Senate Office Building
Washington, D.C. 20510

July 10, 2020

Dear Sens. McConnell and Schumer, and Reps. Pelosi and McCarthy:

I write today to express our view on an important policy question: Is federal support needed to support the financing of firms that reorganize in Chapter 11? While there are many forms that federal support could take, we have been studying the possibility of Congress creating a new federal lending program to provide what is commonly referred to as debtor-in-possession loans or "DIP" loans to large firms. Bankruptcy law provides lenders to Chapter 11 firms with special protections that are meant to incentivize lending to troubled companies. In a normal economy, these protections promote liquidity for distressed companies and the ability to access the DIP financing market is a key reason why firms file for Chapter 11 bankruptcy protection. To the extent that the COVID-19 pandemic disrupts the normal functioning of DIP financing markets, the inability of firms to borrow DIP loans would imperil the ability of the economy to recover quickly and adversely affect employment and the country as a whole. While our focus is on the largest corporations, we also sought to study the DIP loan market for small-to-medium sized firms.

As a reminder, I write on behalf of an interdisciplinary group of scholars who study the corporate bankruptcy system and the problems associated with financial distress. We have formed a committee (the "Large Corporations Committee of the Bankruptcy & COVID-19 Working Group" or the "Large Corporations Committee")[1] to analyze the effect of the global COVID-19

[1] The Large Corporations Committee of the Bankruptcy & COVID-19 Working Group is one of four committees that is part of a larger group studying financial distress and COVID-19, each focused, respectively, on either (1) large corporations, (2) small businesses, (3) consumers, or (4) municipalities. The Large Corporations Committee includes, with institutional affiliations included for identification purposes only: Barry Adler (New York University School of Law), Edward Altman (New York University Stern School of Business), Ken Ayotte (University of California Berkeley Law), Efraim Benmelech (Northwestern University Kellogg School of Management), Diane Dick (Seattle University School of Law), Jared A. Ellias (University of California Hastings College of the Law), Stuart Gilson (Harvard Business School), Edith Hotchkiss (Boston College Carroll School of Management), Troy McKenzie (New York University School of Law), Greg Nini (Drexel University LeBow College of Business), Michael Ohlrogge (New

pandemic on large American businesses and to consider changes that might be needed to improve the ability of the bankruptcy system to cope with the crisis.

The Large Corporations Committee of the Bankruptcy & COVID-19 Working Group has three recommendations to share today based on our review of market conditions. **First**, based on our analysis of recent and historic data, we believe that there is sufficient liquidity in the private sector to provide for the financings of large corporate[2] bankruptcies, and that there is no present need for an additional federal lending facility targeted at large companies that file for Chapter 11. **Second**, as a matter of principle, we believe that federal lending facilities should be available to Chapter 11 debtors on the same conditions and terms as any other firm. Accordingly, we urge you to revise the existing CARES Act facilities and ensure that future lending facilities do not discriminate against Chapter 11 firms. **Third**, while larger bankrupt corporations appear to have sufficient liquidity to accomplish a successful reorganization as things stand today, we believe that federal lending programs could play an important role in supporting the financing market for smaller corporations that seek to reorganize in Chapter 11. We explain each of our views in turn below.[3]

First, based on the available evidence, we believe that there is no current need for a new federal loan facility for larger firms reorganizing in Chapter 11. As we explain further in the Appendix, we studied the historic use of DIP lending by large firms that filed for bankruptcy over the past twenty years. Assuming that the current pace of bankruptcy filings continues, and making conservative assumptions about the amount of distressed assets and liabilities that will need to be reorganized in Chapter 11, we project that the large firms that file for bankruptcy between now and the end of 2021 could need between $33 billion and $93 billion in DIP financing. For comparison's sake, as of May 2020, private investment funds that specialize in distressed investing, special situations and direct lending have at least $267 billion dollars in capital for new investments, which the financial industry refers to as "dry powder."[4] This dry powder can be deployed for making investments in Chapter 11 firms. Additionally, the Federal Reserve has reported that American banks are strong, and news reports suggest that that the fundraising environment is robust, suggesting additional private capital could flow into DIP loans. While not all of this capital will be used for DIP loans, some of it will be, and our qualitative assessment is that the amount of capital that large corporations will need to navigate Chapter 11 is proportionate to the resources of the private sector. Accordingly, we believe that scarce federal resources would be better focused elsewhere. Importantly, this analysis reflects conditions as of June 2020, and we may revisit this view if economic conditions change.

York University School of Law), Robert K. Rasmussen (University of Southern California Gould School of Law), Mark Roe (Harvard Law School), Steven L. Schwarcz (Duke University School of Law), Alan Schwartz (Yale Law School), Lindsey Simon (University of Georgia School of Law), David C. Smith (University of Virginia McIntire School of Commerce), Frederick Tung (Boston University School of Law), George Triantis (Stanford Law School), Wei Wang (Queen's University Smith School of Business) and Jay Westbrook (University of Texas School of Law). This Letter represents the consensus view of the Large Corporations Committee, all of whom are signatories. Additional members of the Working Group who agree with our recommendations are listed as additional signatories below.

[2] We define "large corporations" or "large firms" as firms with more than $50 million in assets, as we explain further in the Appendix.

[3] Another scholar who is not on the committee, but who is part of the larger Bankruptcy & Covid-19 Working Group, has reached a similar conclusion. *See* David Skeel, Bankruptcy and the Coronavirus Part II, Brookings Institution (July 6, 2020).

[4] *See* Preqin Quarterly Update: Private Debt Q1 2020.

Second, as a policy matter, we believe that firms reorganizing in bankruptcy should be able to access all current and future COVID-19 relief lending facilities on terms similar to those of nonbankrupt firms. As things stand, firms have to choose between the traditional protections of bankruptcy law and, for example, the Paycheck Protection Program. That is a missed opportunity. The bankruptcy system provides important tools for firms that need to reorganize, including the ability to obtain the protection of an automatic stay of debt collection. Bankruptcy lawyers and judges are available to help put federal money to work to save troubled companies, and companies should not be forced to choose between the traditional bankruptcy toolbox and access to a federal lending program. Both are important to give viable firms the chance to survive and emerge from bankruptcy as a going concern. Importantly, bankruptcy law could provide extra protection for federal loans that will protect taxpayer money if a lending program requires repayment of the loan, and bankruptcy courts provide judicial oversight and transparency. Strong federal policies and existing law support a general approach of nondiscrimination toward Chapter 11 firms, and future COVID-19 relief bills should conform to these long-standing public policies. Viable firms restructuring their operations in bankruptcy court in response to the pandemic are just as worthy of federal support as viable firms that are restructuring outside of bankruptcy and a nondiscriminatory approach will make the federal lending programs more useful for a wider range of firms. Therefore, all existing government lending programs should, in our considered opinion, be revised to provide access for Chapter 11 debtors.

Third, while we do not have enough historical data to come to firm conclusions, we believe that making federal lending facilities available to Chapter 11 firms could be impactful for small-to-medium sized firms. These small-to-medium sized firms often look for financing from relationship banks, but those lenders may not have deep experience with Chapter 11 lending. With the enormous dislocations in the economy, many otherwise viable smaller firms will be forced into financial distress and liquidation through no fault of their own and Chapter 11 could be an important tool for reorganizing these companies and the jobs they provide. Bankruptcy law can provide government capital with protections that would not be available outside of bankruptcy and limit the potential losses to the economy and taxpayers. Moreover, because the most experienced DIP lenders now generally focus their efforts on larger firms where economies of scale allow large amounts of capital to be put to work, federal support may be especially crucial for smaller firms that seek DIP loans. This is especially so if private lending does not adjust to any rising need for small businesses and if the economy would be best served by stabilizing these small businesses. In sum, we believe that all current and future CARES Act lending facilities should be accessible by Chapter 11 firms and that Congress should empower the federal government to make loans through Chapter 11 in this unprecedented emergency if regulators believe that doing so is consistent with federal policy goals.

Sincerely,

/s/ Jared A. Ellias

Jared A. Ellias, Chair
Large Corporations Committee of the Bankruptcy & COVID-19 Working Group

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[*] "Additional Signatories" are members of the Bankruptcy & COVID-19 Working Group who are not part of the Large Corporate Committee but elected to sign this Letter because they support its conclusions. Institutional affiliations are included for identification purposes only.

[†] Denotes Bankruptcy & COVID-19 Working Group organizer.

APPENDIX

Estimating the Need of Large Firms for DIP Financing During COVID-19[1]

Estimation Performed as of July 1, 2020

In this Appendix, we offer an estimate of the amount of DIP financing that the markets will need to fund the anticipated number of large to middle market Chapter 11s that our model predicts will occur between July 1, 2020 and the end of 2021. As we explain in greater detail below, our approach was to first look at how much DIP financing firms have historically needed to reorganize. We then make predictions about the number of large firm bankruptcy filings between now and the end of 2021, and we assume that these bankruptcies will require capital at a similar rate as has been the case in the past. We take three different approaches to calculating the amount of capital that will be needed to fund the coming wave of bankruptcies, and we emerge with an estimated range of **$33 billion to $93 billion, with a median estimate of $65 billion**. We believe that this range is within the ability of financing markets to meet the anticipated demand for large firm DIP loans, but we will continue to monitor the situation, and we will return to this question as new facts emerge.

I. Data Sources.

We began by examining the historic use of DIP financing.[2] We started by identifying three samples of historic and recent bankruptcy filings:

1) Large Firm Historic Sample. The first sample consists of all Chapter 11 filings by American public companies between 1996 and 2019 with at least $100 million in assets (in constant 1980 dollars) at filing. This sample contains information on 817 large firms that filed for bankruptcy between 1996 and 2019, of which 64% obtained DIP financing.

2) Middle Market to Large Firm Historic Sample. The second sample consists of all Chapter 11 filings by American public companies with at least $50 million in assets (in nominal dollars) at filing. This sample consists of 1,072 middle market to large firms that filed for bankruptcy between 1996 and 2014, of which about 60% obtained DIP financing.

[1] This analysis is the work of the DIP Loan Subcommittee of Fred Tung (Chair), Ed Altman, Jared A. Ellias, Michael Ohlrogge and Wei Wang. Wei Wang performed the analysis, which draws on research he has performed on DIP lending as well as new data from the sources identified. Edward Altman provided projections based on data compiled so far in 2020. The authors thank Jacob Barrera, Spencer Kau, Victor Mungary, Julia Staudinger, and Sara Zokaei for their helpful research assistance.

[2] The sample of Chapter 11 firms is drawn from the UCLA-LoPucki Bankruptcy Research Database, New Generation Research's bankruptcydata.com, and PACER.

3) Recent Bankruptcy Sample. The third sample consists of the 99 firms that filed for bankruptcy between January 1, 2020 and June 30, 2020, with assets of at least $50 million (in nominal dollars), including 43 public companies and 56 private firms. Combined, these firms have about $188 billion in assets and owe about $182 billion in liabilities to creditors.[3]

II. Projecting the Number of Bankruptcies through the end of 2021.

We take a straightforward approach to projecting the number of Chapter 11 filings over the next 18 months and assume that we will see a similar rate of filings to what we have seen through the first half of 2020. Using simple extrapolation, we project that the total filings, total assets, and total liabilities of Chapter 11 filings for the two year period of 2020-2021 will be 398 (=99×731/182) filings, $756 billion (=$188×731/182) total assets, and $730 billion (=$182×731/182) in total liabilities, respectively. Because COVID-19 did not begin to seriously impact the economy until March, these may be conservative estimates.

III. Estimating the Amount of DIP Loan Capital Needed.

Estimation is inherently an inexact science, so we consider three different ways to estimate the amount of capital that large firms will need to reorganize through Chapter 11. Our analysis projects the need for capital between the date of this analysis and the end of 2021.

1) Simple Extrapolation. First, we assume that firms filing for Chapter 11 between July 1, 2020 and December 31, 2021 will need a similar amount of capital to the firms that filed for bankruptcy in the first five months of this year.

> The firms in the Recent Bankruptcy Sample, which consists of all public and private firms with assets of greater than $50 million that filed for Chapter 11 between January 1, 2020 to June 30, 2020 obtained **about $10.8 billion in DIP financing.**
>
> If we assume that the next 18 months looks similar, the firms filing for bankruptcy between July 1, 2020 and December 31, 2021 will need about **$33 billion (=$10.8×731/182-$10.8) in DIP financing.**

2) Regression Approach. Second, we use regression analysis to estimate the need for DIP financing using the historic data from, in separate analyses, the Large Firm Historic Sample and the Middle Market to Large Firm Historic Sample. The intuition is that we estimate the amount of DIP loan capital that firms have needed as a ratio to the amount of assets and liabilities under bankruptcy court administration. After generating those estimates, we apply them to the anticipated amount of assets and liabilities that the bankruptcy system will reorganize between now and December 31, 2021 and estimate the amount of capital needed if the historic relationship between the amount of DIP loan capital needed to reorganize assets and liabilities remains intact.

[3] For firms for which we do not have information on the actual amount of assets and liabilities at Chapter 11 filing, we use the lower bound of the range of assets and liabilities indicated in their petition forms.

For each of the Large Firm Historic Sample and the Middle Market to Large Firm Historic Sample, we run regression models with the following specification for each large firm *x* and each sample year *y* for the assets and liabilities noted on the bankruptcy petition:

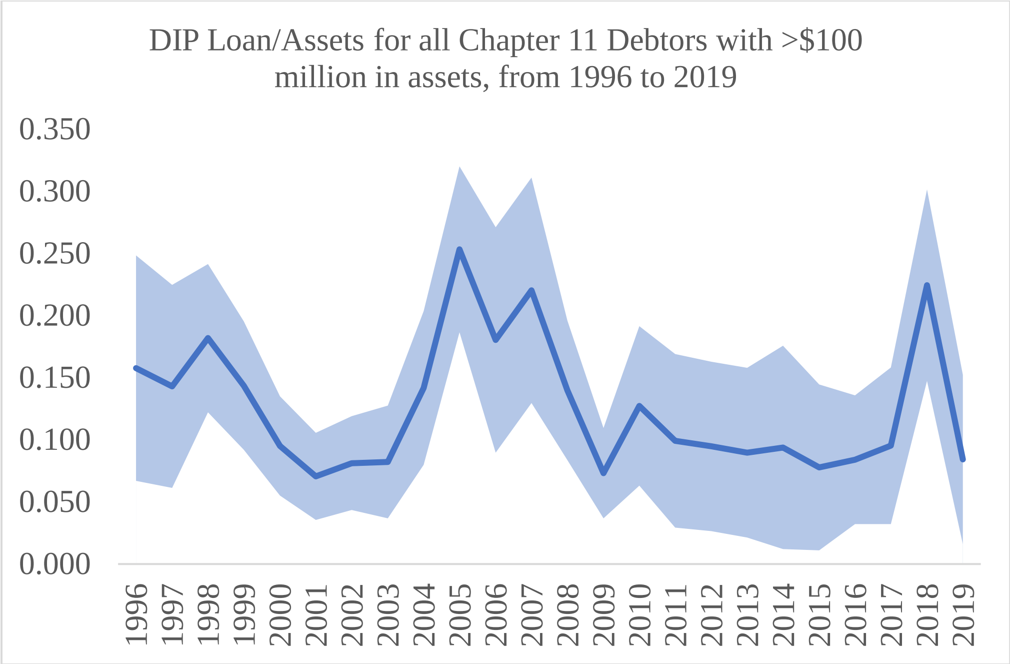
$$(1)\ \frac{DIP\ Loan_x}{Petition\ Assets_x} = \alpha + \beta \mathrm{Year_y} + \varepsilon$$

$$(2)\ \frac{DIP\ Loan_x}{Petition\ Liabilities_x} = \alpha + \beta \mathrm{Year_y} + \varepsilon$$

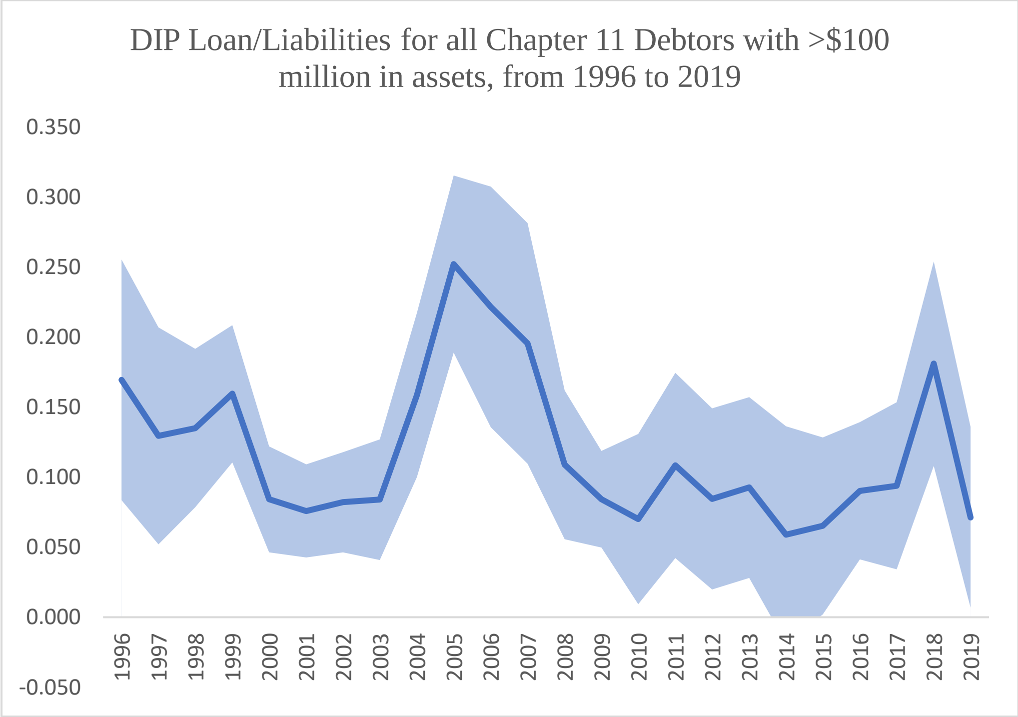
The variables of interest are the year dummy variables, $\mathrm{Year_y}$,which take on a value of 1 for each sample year ranging from 1996 to 2014 or 2019, depending on the sample. We use these year dummy variables to estimate 95% confidence intervals for each sample year.[4]

We show the year-by-year confidence intervals below. As the Figures show, there are some variations over time (e.g. the estimates are generally lower during the recessions of 01-02 and 08-09) with the mean ranging between 6% and 24% for the two samples. Using the DIP-loan-to-assets models, we find that the 95% confidence interval is [9.8%, 12.1%] for the large firm sample and [9.0%, 11.0%] for the large to middle market firms. Using the second model, where DIP-loan-to-liabilities is the dependent variable, we find that the 95% confidence interval is [9.4%, 11.6%] for the large firm sample and [9.3%, 12.3%] for the large to middle market firms. For the Large Firm Historic Sample, the mean of the year dummies across the sample period is 11% in the DIP-loan-to-liabilities specifications and 10% for the DIP-loan-to-assets specifications. Similarly, in the Middle Market to Large Firm Historic Sample models, we estimated a mean year-dummy coefficient of 11% for the DIP-loan-to-liabilities specifications and 10% for the DIP-loan-to-assets specifications.

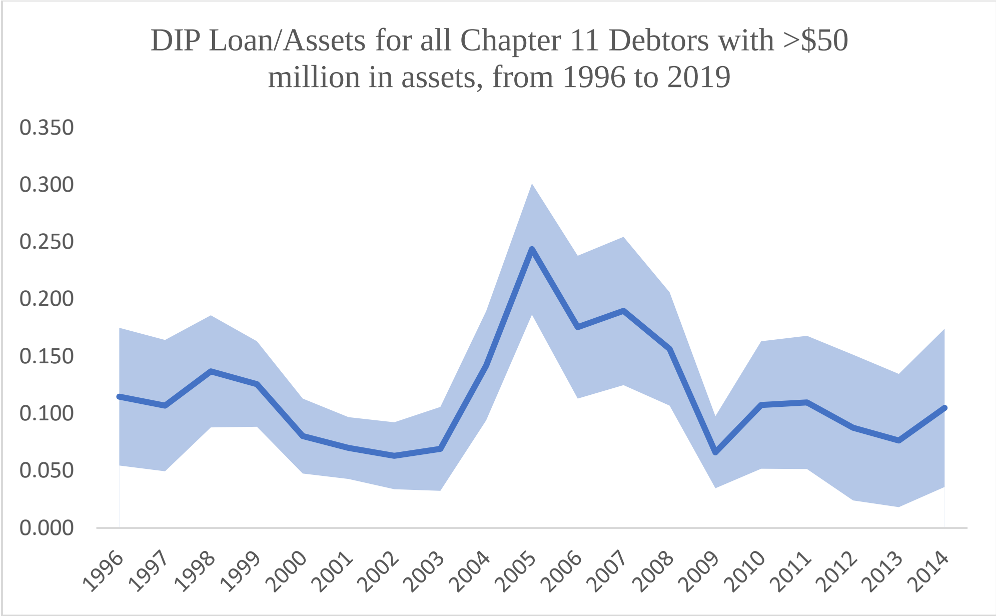
[4] Each ratio is set to 0 if the firm reorganized without a DIP loan.

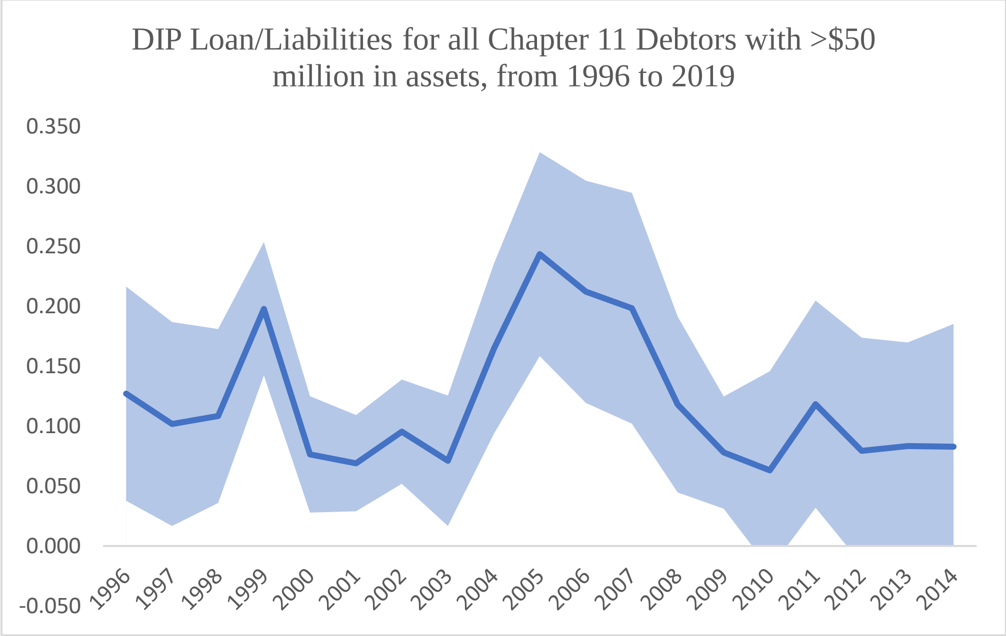


DIP Loan/Assets for all Chapter 11 Debtors with >$100 million in assets, from 1996 to 2019
0.350
0.300
0.250
0.200
0.150
0.100
0.050
0.000
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019



DIP Loan/Liabilities for all Chapter 11 Debtors with >$100 million in assets, from 1996 to 2019
0.350
0.300
0.250
0.200
0.150
0.100
0.050
0.000
-0.050
1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019





Using these confidence intervals and assuming that the DIP-loan-to-assets and the DIP-loan-to-liabilities ratios stay constant over the next 18 months, we estimate that the firms that file for Chapter 11 bankruptcy between now and the end of 2021 will be in the range of **$57 billion to $79 billion** for firms with assets of $50 million in assets or higher.

3) For an alternative approach, we make assumptions about the amount of risky debt outstanding and assume a 20% default rate and use that as the basis for the analysis instead of our projection of the estimated volume of Chapter 11 filings.[5]

   - We estimate the total amount of high yield bonds, leverage loans and non-investment grade private credit outstanding to be around $3.3 trillion.
   - We assume a 20% cumulative default rate from 2020-21.
   - We assume that large Chapter 11 firms' average total debt-to-assets ratio at filing will be 0.7.[6]

   This analysis suggests that $943 billion of risky debt will need to be reorganized in Chapter 11. If we use the confidence intervals estimated above to determine how much DIP loan capital will be needed, we estimate that large firms will need between **$74 billion and 93 billion** to fund Chapter 11 bankruptcies**.**

Estimates: Combining our estimates, our methodology suggests that the population of large firms that file for Chapter 11 bankruptcy will need between **$33 billion and $93 billion**, with a mid-point estimate of **$65 billion.**

IV. Assessing the Ability of the Private Sector to Meet the Anticipated Need for DIP Loan Capital.

Finally, we examine whether the private sector will be able to supply the amount of DIP loan capital that firms will need without federal intervention. Data from Preqin suggests that asset managers specializing in direct lending, distressed debt or special situations, which are often deployed for DIP loans, currently have more than $267 billion in "dry powder" for new investments. Press reports suggest that fund managers are in the process of raising tens of billions of dollars in additional capital and that investor interest in the strategy is high. While not all of this capital will be deployed for DIP loans, some of it will be, and fund managers appear to have the ability to raise additional capital if the opportunity to put it to work arises. Additionally, traditional banks appear to be well-capitalized and historically have made DIP loans themselves.

As the supply of capital under the control of potential DIP lenders appears proportionate to the need that large firms will have, we do not believe that explicit federal intervention in this large firm market is warranted at this time.

[5] This projection is consistent with the discussion in Section 3.2 of Edward I. Altman, *Covid-19 and the Credit Cycle*, 16 J. CRED. RISK 67 (2020).
[6] This is the average debt-to-assets ratio from the 981 Chapter 11 filings with more than $50 million in assets that filed for bankruptcy between 1996-2014.