DIP (Debtor-in-Possession) Rating Criteria

Cross-Sector Criteria

Table of Contents

This report updates and replaces *DIP (Debtor-in-Possession) Rating Criteria* dated November 25th, 2019.

Related Criteria

Corporate Rating Criteria. (May 2020)

Corporates Notching and Recovery Ratings Criteria (October 2019)

Non-Bank Financial Institutions Rating Criteria (February 2020)

Analysts

Judah Gross
+1 212 908 0884
judah.gross@fitchratings.com

Lyuba Petrova
+1 646 582 4885
lyuba.petrova@fitchratings.com

Maude Tremblay
+312-368-3203
maude.tremblay@fitchratings.com

Scope

This report specifies Fitch Ratings' methodology for assigning new international credit ratings to debtor-in-possession (DIP) instruments issued by companies across multiple sectors who are debtors under the U.S. bankruptcy code. The methodology applies equally to both DIP loan facilities and DIP bond issuances and no qualitative distinction between loan or bond debt affect the application of the methodology. In the case of a DIP bond transaction, any reference to "facility", "loan", or "lender" in this report may be read to include reference to "issuance", "instrument", or "holder".

The ratings address the relative vulnerability to default and repayment in full prospects of DIP facilities. A default results from non-payment of interest, principal or fees on the DIP facility on periodic payment dates and at the time of bankruptcy exit. Fitch's DIP instrument ratings are point in time. Fitch withdraws the DIP rating within one business day of assignment. No rating Outlooks are assigned.

DIP instrument ratings are not linked to the bankrupt company's Issuer Default Rating (IDR) of 'D', nor to any future rating for the reorganized company that may be issued on or after the bankruptcy exit date.

A DIP lender voluntarily electing to take distributions on DIP claims in a form other than cash per the original terms of the agreement, such as repayment by conversion to new exit facility debt issued on the reorganization date, is not considered a diminution of recovery or a DIP event of default.

The protections provided by the U.S. bankruptcy code result in unique rating considerations. Companies in bankruptcy benefit from an automatic stay preventing pre-petition creditor actions and an ability to reject economically burdensome executory contracts. In addition, DIP instruments usually have a superpriority administrative priority claim status, and these claims must be paid in full for a plan to be confirmed. The financing order from the bankruptcy judge sets forth the key facility features and is analysed by Fitch in the rating process.

Key Rating Drivers

Collateral Value to DIP Loan: Fitch performs an assessment of the DIP facility collateral to the fully drawn facility. If the DIP instrument is secured by all assets, a going concern enterprise valuation is performed, following the methodology detailed in the *Corporates Notching and Recovery Ratings Criteria*, or a select methodology Fitch considers more appropriate for a given sector. If the facility is secured by discrete assets, an analysis of the asset value is completed for this factor. This factor tends to be the most important factor in DIP issue rating outcomes.

Facility Structural Attributes: The elements of the structural attributes analysis include an assessment of the DIP claim rank, collateral package scope, loan payment priority and other contractual terms. An assessment of the relative strength of these protections is typically the second most influential issue rating input.

Post-Petition Liquidity and Cash Flow: Fitch analyses the company's projected cash sources and uses during bankruptcy to determine the sufficiency of liquidity relative to cash needed to maintain operations through completion of the restructuring or liquidation process. The cash flow and liquidity forecast is facilitated by the Corporate Modeling and Forecasting model

(Comfort) that is further described in the *Corporate Rating Criteria*, or by other appropriate analysis relevant to the issuer's specific sector.

Prospects and Restructuring Scope: This factor encompasses the likelihood of emergence as a going concern, the breadth and depth of restructuring needs, and the company's scale and diversity.

DIP Instrument Rating Capped at 'BBB+': Given the inherent uncertainty of bankruptcy reorganization processes, Fitch will not rate DIP instruments higher than 'BBB+'.

Framework for Practical Application

In most DIP ratings, the ratio of collateral value to loan and the facility structural attributes are the more influential rating factors. However, if the post-petition liquidity and cash flow rating factor or prospects and restructuring scope factors are considered to be particularly weak, either of these factors can significantly weigh on the instrument rating. Moreover, a very weak structural feature, such as no payments to DIP facility holders on the exit date unless a pre-petition obligation is fully paid, would result in a very low DIP issue rating, even if the collateral value coverage of the DIP loan was considered to be very strong.

Moreover, if the company value to DIP loan coverage is near the low end of the range for a rating category — for example a 'BBB' coverage factor outcome based on a 3.1x estimated value to loan, and the other rating factors are consistent with a 'BB' outcome — the committee is likely to elect to assign a 'BB' category issue rating.

Not all elements within each of the five key rating drivers outlined in this report apply to every individual instrument rating. Each specific rating action commentary or rating report will disclose the factors and elements most relevant to the individual issue rating. Within rating categories, Fitch may use modifiers. The modifiers "+" or "–" may be appended to a rating to denote relative status within a rating category.

DIP instrument ratings are point in time and therefore not sensitive to changes in assumptions.

On emergence, Fitch may assign a new IDR and debt issue ratings based on an analysis of the exit capital structure. In many cases, the reorganized company would have a more leveraged capital structure at the time of exit than during the bankruptcy proceeding. As a result of the higher exit leverage, the post-emergence IDR and debt issues would often be rated lower than the DIP issue rating.

Fitch analysts use a DIP rating factor input chart to illustrate the key rating factor inputs to the DIP facility rating output in the rating process. An illustrative chart example is below.

Company XYZ Key DIP Issue Rating Factor Inputs

Factor levels	Company value to DIP loan	Structural attributes of DIP facility	Post-petition cash flow and liquidity	Prospects and restructuring needs	DIP issue Rating
bbb+					BBB+
bbb					BBB
bbb–					BBB–
bb+					**BB+**
bb					BB
bb–					BB–
b+					B+
b					B
b–					B–
ccc					CCC

Note: Red lines are more significant factors. Bolded DIP issue rating approximates the rating output.
Source: Fitch Ratings

DIP Instrument Key Rating Factors

Rating factor and elements	CCC category DIP rating	B category DIP rating	BB category DIP rating	BBB category DIP rating
Collateral value to loan				
Going Concern Enterprise Value/DIP Loan or Liquidation Value/DIP Loan or Asset Value/DIP Loan (Numerator input depends on specific collateral for DIP and expected case outcome.)	Collateral coverage of fully drawn DIP loan of approximately 1.1x or less. Secured by illiquid, difficult to value or intangible collateral assets.	Collateral coverage of fully drawn DIP loan > 1.2x and < 2.0x coverage of the fully utilized DIP loan, limited excess value available. Less liquid collateral with greater volatility of value.	Collateral coverage of fully drawn DIP loan ≥ 2.0x and ≤ 3.0x, providing material value margin, even in downside/stress scenario. Active secondary market exists for collateral, may have third-party appraisal of value.	Collateral coverage of fully drawn DIP loan ≥ 3.0x the fully utilized DIP loan, providing significant overcollateral, even in downside/stress scenario. Secured by more liquid, readily marketable collateral assets with more stable valuation. Recent traded values of like assets support valuation.
Structural attributes of DIP facility				
Claim and collateral	Unsecured or substandard collateral package. Lacks superpriority claim status.	Limited or less liquid collateral package with superpriority administrative claim.	Secured by key strategic assets or all assets with a superpriority administrative claim.	Secured by all or key assets with a superpriority administrative claim basis.
Lien or payment priority position	Second- or third-lien DIP or first liens limited to assets consisting of less easily valued assets, such as IP or trademarks with uncertain value.	First lien on limited or less liquid collateral.	Priming first lien on working capital assets or first lien on valuable unencumbered assets.	Priming first lien on key assets or blanket first lien or lien on valuable unencumbered assets.
Other structural attributes	Lacks maintenance covenants and reorganization milestones.	Weak structural protections that limit lender ability to control the reorganization process, weak mandatory prepayment terms.	Some protective features, such as reorganization milestones, and one or more minimum cash flow or liquidity maintenance covenants.	Numerous protective attributes that provide strong lender control, such as: realistic reorganization timeline milestones; reporting requirement to submit rolling EBITDA forecasts; restrictive maintenance covenants, such as minimum liquidity or EBITDA; ABL borrowing base structure; subsidiary guarantees from all material subsidiaries.

DIP Instrument Key Rating Factors (Cont.)

Rating factor and elements	CCC category DIP rating	B category DIP rating	BB category DIP rating	BBB category DIP rating
Post-petition cash flow and liquidity				
Post-petition new money access	DIP facility sized only to roll up pre-petition secured debt, no incremental new money committed by lenders to DIP.	Modest new money commitment.	DIP includes material new money commitment.	DIP includes sizeable new money commitment indicating continuing ability to raise debt funding and high lender confidence of successful outcome
Post-petition free cash flow (FCF)	Significantly negative FCF expected despite automatic stay of liabilities.	Nominally positive FCF, but uncertain trajectory and DIP borrowings may become a primary source of funding.	Consistent FCF expected at levels adequate to sustain the business with moderate exit leverage.	Significant FCF will likely lead to early pay-down of DIP debt and/or build-up of cash on hand; FCF easily sufficient to service DIP and other bankruptcy period cash flow needs with large excess. FCF several multiples of bankruptcy period cash needs.
Credit market conditions	Tight credit, little new issuance; flight to quality limits access to riskier issuers, reduced vendor terms.	Credit markets volatile, but remain accessible; some concern over willingness of trade vendors to supply company on terms that support viability.	Adequate credit access and vendor terms expected. Balanced credit markets.	Robust credit environment that supports debtors' ability to obtain exit financing or raise new equity capital. Continued trade vendor support and credit.
Prospects and restructuring needs				
Likelihood of emergence as a going concern	Significant uncertainty surrounding ability to reorganize; greater liquidation risk. Few compelling reasons to continue to exist, and serious operational flaws or in trough.	Some uncertainty on likelihood of emerging as going concern; reorganization as going concern may be hampered by complex multitier, multi-issuer capital structure with contentious intercreditor issues; or complex union, environmental remediation or legal issues to be addressed during bankruptcy. No restructuring support agreement or pre-negotiated plan in place on petition date.	Highly likely to continue as a going concern; straightforward path to emergence and liability structure with no major intercreditor issues. May have pre-filing restructuring support agreement in hand with requisite majorities of creditor classes and no material operational restructuring objectives.	Near certain continued operation. DIP may be structured to convert to an exit facility or negotiated concurrently with a restructuring support agreement that lays out terms of the reorganization plan; prepackaged or pre-negotiated plan.

DIP Instrument Key Rating Factors (Cont.)

Rating factor and elements	CCC category DIP rating	B category DIP rating	BB category DIP rating	BBB category DIP rating
Company scale and diversity	Small scale, lacks diversity of products/services ; may depend on a single or small number of products, or operate in a limited geographic area.	Limited geographic or product diversity; stagnant or declining market share.	Medium size, some breadth of product or services. Company has defensible niche market, some unique attributes.	Company is among largest in its market segment, national or global scale.
Key bankruptcy drivers and scope of restructuring needs	Long-term secular decline in demand for product or service; technological obsolescence of product of service, severe operating challenges in addition to overleverage.	Flawed business operations, but considered salvageable with operational fixes, widespread non-debt liability and debt-restructuring requirements.	Cyclical downturn that persists into post-petition period at trough levels, with no uptick expected in near term. Competitive assets, but multiple restructuring objectives that may include operations, contracts, etc.	Highly leveraged operations encountered business or legal judgement setback that is resolvable. Sound operations, competitive assets. Restructuring primarily focused on fixing the debt structure (e.g. overleveraged due to LBO) or a single type of non-debt structure (e.g. union labor costs). Highly competitive assets and leading business position in market.

DIP – Debtor-in-Possession. ABL – Asset-Backed Loan
Source: Fitch Ratings

Collateral Value to DIP Loan

Assessing the ratio of value to the fully drawn DIP facility is the primary DIP issue rating factor, and accounts for a significant portion of the issue rating outcome. If the DIP facility is secured by all assets, the numerator is the company's estimated enterprise value if Fitch expects the company to emerge as a going concern. If the collateral is limited to specific assets, such as receivables or an aircraft, Fitch will use an estimate of the value of these discrete assets in the analysis. Fitch's enterprise valuation, or liquidation valuation, process for issuers of DIP loan ratings follows the methodology detailed in the *Corporates Notching and Recovery Ratings Criteria*, or a select methodology Fitch considers more appropriate for a given sector.

If Fitch rated the pre-petition issuer, the valuation done on or prior to the bankruptcy filing date informs the post-petition collateral valuation performed for the DIP issue rating. Fitch also evaluates any new information or appraisals provided on the collateral asset or enterprise value, including any lender or other third-party estimates of the company's fundamental value or appraised values for individual assets included in the security package.

The value is divided by the fully drawn DIP loan, plus pari passu loans/facilities or claims, to assess the degree of overcollateralization for the DIP loan.

A second-lien DIP claimholder would be entitled to repayment following the issuer repaying in full the more senior DIP claimholder. Therefore, the facility with the junior lien would be consistent with a weaker collateral value/DIP loan factor result.

The scope, types and liquidity of the DIP collateral assets influence Fitch's collateral assessment. A DIP secured by more liquid readily saleable assets would be considered as stronger collateral compared with a facility secured by intangible or potentially illiquid assets.

Facility Structural Attributes

The elements in the structural attributes analysis include an assessment of the DIP claim rank, loan payment priority and other contractual terms, such as the presence and relative strength of maintenance covenants, reorganization process milestones, guarantees and other features that collectively provide control to lenders. Fitch uses the bankruptcy court DIP financing order and the facility term sheet (or draft credit agreement if available) to evaluate the level of protection afforded by structural attributes of the DIP facility.

A key structural element is the superpriority administrative claim status of the DIP lender's claim that is granted and binding by bankruptcy court order. This status permits the lender to receive full cash repayment at the time of emergence from bankruptcy ahead of pre-petition creditors and before other administrative expenses in the payment priority liability waterfall.

The other key structural attributes are the lien rank and payment priorities provided by the security package. A priming first lien on assets or first lien on valuable, previously unencumbered assets are relatively stronger security package features that support a more favourable assessment of the structural attributes. If multiple DIP tranches or facilities exist that have different lien or payment priorities, the tranche with first-out payment priority and a first lien on more liquid or readily saleable assets would be viewed as having stronger structural attributes than a tranche with a junior lien or second-out payment priority.

There is a range of structural features that increase control of the DIP facility lenders over the restructuring process and support a stronger structural rating factor, including ABL facility structure, lender cash dominion, tight mandatory prepayment provisions and maintenance covenants for minimum EBITDA. The presence of restructuring milestones, such as a deadline for filing a disclosure statement or proposing a restructuring plan, also increases lenders' control. These features contribute to a strong structural attribute rating factor, but are less critical than the superpriority administrative priority status of the DIP claim.

Post-Petition Liquidity and Cash Flow

Fitch analyzes whether there is sufficient liquidity to fund the company's cash operating and other needs in the bankruptcy process, and assesses whether the DIP debt service and other liquidity needs are manageable compared with projected cash flows during bankruptcy. This liquidity forecast is facilitated by the Comfort model or by other appropriate analysis relevant to the issuer's specific sector.

DIPs that include new money facility, rather than a commitment amount sufficient only to roll-up of pre-petition secured debt, contribute to a stronger post-petition liquidity and cash flow assessment. Raising new money demonstrates a continued ability to raise debt financing. Similarly, if an issuer has significant cash and equivalent assets on the bankruptcy filing date and/or a Fitch projection of positive FCF following the automatic stay of pre-petition obligations, it can lead to a stronger assessment of this rating factor.

A large amount of pre-petition debt rolled into the DIP facility can strain post-petition liquidity. If the commitment size of DIP facilities is close to the amount to pre-petition debt obligations as a result of a large roll-up, the debt service burden during bankruptcy may present a continuing drag on cash flow and liquidity.

Signs of weak liquidity and cash flow rating factors include negative FCF and projected continued need to use the DIP to fund cash flow deficits despite the stay of pre-petition debts, a large roll-up of pre-petition debt with nominal new money commitment, and/or a secular decline of the business that is likely to further reduce already strained liquidity and cash flow.

Fitch analyzes the projected cash inflows versus cash outflow only for the Chapter 11 period, rather than a multiyear base and stress case forecast that would be done in a performing issuer's IDR analysis. Typical performing issuer leverage metrics used in corporate rating methodologies, such as debt/EBITDA or debt/cash flow from operations, are much less meaningful in assessing ratings for DIP issuers, because the pre-petition liabilities of the company are subject to compromise during the bankruptcy process and EBITDA is likely to be bottoming out at the outset of a case. The company may make operational fixes during the case, such as rejecting contracts or shutting poor divisions to improve EBITDA, but these fixes are not yet done at the outset of a case, and there is uncertainty as to how successful these efforts will be.

Finally, issues such as adverse credit markets at the time of the DIP financing, with a flight to quality and very little new issuance activity in leveraged markets, and/or the company's vendors materially reducing credit terms could result in a weaker liquidity and cash flow assessment. This environment can severely limit access to successful reorganization and access to sufficient debt and equity exit financing to repay the DIP, and limit the ability to sufficiently capitalize the reorganized company.

Prospects and Restructuring Scope

Bankruptcies filed with a pre-packaged or pre-negotiated bankruptcy plan and restructuring support agreement that lays out the terms of the restructuring in place would receive a relatively strong assessment for prospects and restructuring scope. These cases are often straightforward debt/equity swaps and do not entail major operating or employee benefit restructuring needs. Similarly, a DIP facility structured to convert to an exit facility upon emergence would support a relatively strong assessment for restructuring prospects.

Cases that have many operational restructuring objectives in addition to balance sheet debt-reduction objectives would be relatively weaker in the prospects and restructuring scope factor because these complex issues could take years to resolve and the business environment could deteriorate during this period. The more protracted the case, the more likely business conditions could worsen during bankruptcy. Examples of more complex operational restructuring objectives include addressing union collective bargaining contracts; legacy liabilities, such as retiree health and pension obligations; or uneconomic executory contracts that will be rejected in the Chapter 11 process. The need to close numerous unprofitable facilities or make significant union employee headcount reductions are additional examples.

A complex credit structure with multiple borrowing entities can result in intercreditor disputes and lead to a longer time in bankruptcy and more challenging restructuring process.

The presence of numerous and/or complex operational restructuring makes the path to reorganization as a going concern more uncertain and lengthier, and results in a weaker assessment of this rating factor.

Companies that lack diversity of products/services, are in secular decline or are subject to intense competition with persisting business challenges would also be likely to have a weaker assessment of the prospects and scope key factor.

DIP Instrument Rating Cap

Given the inherent uncertainty of bankruptcy reorganization processes, Fitch will not rate DIP instruments higher than 'BBB+'.

Criteria Disclosure

In its initial rating action commentaries, Fitch expects to disclose the rationale for the assessment for each of the key DIP rating drivers, including:

- Assumptions made in valuing the collateral relative to the DIP loan, such as sustainable EBITDA and going concern exit multiple in a going concern enterprise valuation for a DIP secured by all assets, or discrete asset valuation details for a DIP secured by specific assets;
- Sector-specific valuation assumptions that differ from our standard methodology applied in the *Corporates Notching and Recovery Ratings Criteria*;
- A description of key structural features of the DIP facility, such as priority, collateral, reorganization milestones and covenants, and noteworthy aspects of the bankruptcy judge's DIP financing order, and an assessment of these features;
- An analysis of post-petition liquidity relative to cash needs;

- An assessment of the scope of the restructuring needs and prospects for a timely and successful emergence from bankruptcy as a going concern;
- Disclosure of the most relevant rating factors;
- Any variations from the criteria.

Variations from Criteria

Fitch's criteria are designed to be used in conjunction with experienced analytical judgment exercised through a committee process. The combination of transparent criteria, analytical judgment applied on a transaction-by-transaction or issuer-by-issuer basis, and full disclosure via rating commentary strengthens Fitch's rating process while assisting market participants in understanding the analysis behind our ratings.

A rating committee may adjust the application of these criteria to reflect the risks of a specific transaction or entity. Such adjustments are called variations. All variations will be disclosed in the respective rating action commentaries, including their impact on the rating, where appropriate.

A variation can be approved by a rating committee when the risk, feature or other factor relevant to the assignment of a rating and the methodology applied to it are both included within the scope of the criteria, but the analysis described in the criteria requires modification to address factors specific to the particular transaction or entity.

Limitations

Ratings are subject to the limitations specified in Fitch's Rating Definitions and available at https://www.fitchratings.com/site/definitions.

Data Sources

Key assumptions underlying these criteria are developed by analysis of data on corporate DIP facility performance and vulnerability to default. This includes the analysis of key rating factors and case outcomes. Conclusions are based on bankruptcy case studies done with information provided in court disclosure statements for reorganization plans, public and private sector information and information from market participants. Assumptions are derived from experienced analytical judgement using such information.

Fitch Information Requests for DIP Rating

Summary DIP term sheet and, if available, draft credit agreement.
Court financing order.
Offering memorandum (if DIP is syndicated to new lenders).
Third-party appraisal of collateral or other available collateral valuation information.
Sources and uses for DIP financing.
13-week rolling forecast.
Audited annual financials.

Source: Fitch Ratings

Appendix: Chapter 11 Code Information

The policy goal of Chapter 11 is to provide breathing room to a debtor and encourage reorganization as a going concern, which usually maximizes recoveries for all parties. In Chapter 11, pre-petition lenders are, for the most part, stayed from enforcement remedies, and do not receive interest or principal payments unless the judge approves. Sufficient post-petition DIP funding access results in a higher likelihood of a successful rehabilitation of the business during Chapter 11.

DIP loans are used to supplement internal liquidity to enable the lender to continue normal operations during bankruptcy. DIPs with administrative claim priority must be paid in full to confirm a bankruptcy plan.

The term superpriority refers to the status of the DIP lender's claim for payments ranking superior to other administrative claims in waterfall positions for payment of claims. Administrative expenses (paid during the case) and administrative claims (paid on exit date) are the actual and necessary costs of preserving the estate. Administrative expenses and claims include, but are not limited to, professional fees (lawyers, advisors), taxes, certain environmental remediation costs and DIP financing costs. A superpriority administrative claim has priority over other administrative claims. A DIP facility is often structured with superpriority administrative status because this supersenior status was needed to attract the new financing.

Section (§) 364 of the bankruptcy code is designed to induce lenders to extend credit through a structure that will ensure full repayment of the financing prior to any payment of pre-petition claims, whether the case is resolved as a going concern reorganization or via liquidation.

The bankruptcy court administering the case must hold a hearing prior to permitting a DIP facility be put in place and provide the authorization for the specific DIP financing terms in a court financing order. The protections provided in this section are binding by the court financing order, which often is made very early in the case (first day motions). Fitch will analyze the post-petition financing order as part of the structural rating factor assessment in the DIP rating process.

The following sections are listed because they relate to DIP financing:

(§) 364 of the Chapter 11 code relates to post-petition funding (DIPs).

(§) 364a and (§) 364b authorize a debtor to obtain unsecured credit as a first-priority administrative expense.

(§) 364c authorizes funding on a superpriority basis if funding is not available under (§) 364a and (§) 364. This means the funding has priority over other administrative expenses, and the loan is secured by a lien on unencumbered property or secured by a junior lien on property already encumbered by a lien.

(§) 364d authorizes funding with a lien on encumbered property if funding is unavailable under (§) 364c, as long as adequate protection is provided to the existing lienholder. This is known as a priming lien. Usually, in exchange for a priming lien, the pre-petition secured lender will be paid current interest throughout the bankruptcy, either at the pre-default rate or at the default rate of interest.