Article Title: ARCHIVE | Criteria | Corporates | General: Debtor-In-Possession Financing Data: (EDITOR'S NOTE: —These criteria have been superseded by "Methodology And Assumptions For Rating Debtor-In-Possession Financing," published Sept. 4, 2018.) 1. Standard & Poor's Ratings Services has specific criteria for rating debtor-in-possession (DIP) financing available under Chapter 11 of the U.S. Bankruptcy Code. These criteria take into account some of the unique elements of this type of financing. We are publishing this article to help market participants better understand the key elements of our approach to rating DIP issues and how it is different from the way we rate the debt issues of nondefaulted corporate entities. This article is related to our global corporate criteria (see "Corporate Methodology," published Nov. 19, 2013) and to our criteria article "Principles Of Credit Ratings," Feb. 16, 2011. SUMMARY OF THE CRITERIA 2. DIP issue ratings reflect the: Likelihood that a company will be able to successfully reorganize under Chapter 11 of the U.S. Bankruptcy Code, emerge from bankruptcy as a going concern, and attract sufficient exit financing to fully repay the DIP obligation at emergence. We refer to this as the capacity for full repayment at emergence (CRE), and it serves as the anchor for the DIP issue rating. Potential for a company to fully repay the DIP obligation if it is not successful in reorganizing. Our projected liquidation scenario could involve an outright asset liquidation under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code or a forced sale of the business (under extremely distressed conditions), depending on our view of the business's viability and reorganization challenges. If we believe the DIP financing is sufficiently overcollateralized to be fully repaid under our liquidation scenario, we could assign a rating that is one or two notches higher than the rating indicated by the CRE assessment. The amount of uplift, if any, depends on our estimated level of coverage and our confidence in full repayment. 3. Taken together, a DIP issue rating captures our analytical assessment of the viability (reorganizability) of a company's business and the amount of the DIP obligation relative to the company's value--both as a reorganized entity and if liquidated. 4. Unlike other corporate ratings, DIP issue ratings do not consider the likelihood or capacity for a company to meet all of its obligations in the ordinary course because DIP maturities may be extended beyond the original date. In addition, in these cases, the company has already defaulted on some pre-bankruptcy (prepetition) obligations and could purposely default on others as it works to reorganize and emerge from insolvency. SCOPE OF THE CRITERIA 5. The methodology applies to special-priority DIP financing provided to nonfinancial companies that have filed for bankruptcy reorganization under Chapter 11 of the U.S. Bankruptcy Code. DIP obligations that do not allow lenders to demand full cash repayment upon emergence are governed by additional criteria (see "Update On Rating Methodology For Debtor-In-Possession Loans With Noncash Pay Features," July 30, 2009). 6. This paragraph has been deleted. 7. The information in this paragraph has been moved to the "Revisions And Updates" section. METHODOLOGY 8. Because adequate funding is key to a company's potential for reorganization and emergence from bankruptcy as a viable entity, the U.S. Bankruptcy Code has incentives for lenders to provide financing to companies operating under the protection of Chapter 11. Such post-petition financing is known as DIP financing. 9. Our criteria for rating DIP financing extended to companies in bankruptcy employs the conceptual framework developed for speculative-grade issue ratings. The analysis for DIP financing consists of two parts: The first focuses on timely repayment of the DIP obligation in full at the point the company emerges from bankruptcy; this assessment forms the CRE for the DIP rating. The second focus is the particular aspects of the specific transaction and the potential for recovery on that debt in the event reorganization is unsuccessful and a company is forced to liquidate. The expectation for a full recovery under this downside scenario could lead us to assign a DIP rating that benefits from a one- or two-notch enhancement above the rating indicated by the CRE assessment. Timely payment 10. In the case of DIP obligations, timely payment of principal occurs through the defaulted entity's reorganization, its emergence from Chapter 11, and repayment of the DIP obligation in full at that time. Such payment is considered timely and in accordance with the terms of the agreement--notwithstanding the possibility of a stated earlier maturity--in keeping with the normal expectations. DIP lenders generally are tied in for the duration of the reorganization process, which we assume will conclude within the debtor's exclusivity period under Chapter 11 of the U.S. Bankruptcy Code (which gives the debtor a maximum of 20 months to file its own plan of reorganization). 11. This part of the analysis considers the likelihood of reorganization. A favorable assessment is likely for viable companies, particularly for large, established entities. If the operation is fundamentally healthy but the company is saddled with debt because of a leveraged buyout (LBO), a recapitalization, or an overpriced acquisition, its ability to service a more appropriate debt load via reorganization might be quite strong. 12. However, if there were any significant doubt about the company's viability or its ability to attract sufficient cash to fully repay a DIP obligation at the end of the restructuring process, we would probably assign a low speculative-grade rating. An inferior company in an industry with poor fundamentals or a firm with a seriously flawed business model would be a less likely candidate for rehabilitation and refinancing. Therefore, before considering potential enhancement for full coverage in a liquidation scenario, we would not assign a rating higher than 'B+' to a DIP obligation of a company assessed as having a vulnerable business risk profile based on its restructuring (see "Corporate Methodology," Nov. 19, 2013). Similarly, we would not rate a DIP obligation of a company assessed as having a weak business risk profile based on its restructuring higher than 'BB+' (again, before considering potential enhancement for full coverage in a liquidation scenario). 13. Accordingly, much of the business risk analysis is identical to the fundamental corporate credit analysis relating to a company in the context of its particular industry. This analysis focuses on our prospective view of a company's preliminary competitive position (competitive advantage; scale, scope, and diversity; and operating efficiency), operating history, current cash flow, and ability to operate profitably once it has a manageable capital structure. These factors are substantially the same as the ones we consider when assigning a credit rating to a nonbankrupt company. Our evaluation will also be influenced by the relative complexity, contentiousness, and magnitude of the restructuring actions required. Of course, the taking into account the impact of the bankruptcy itself--on the company's business relationships with its customers, vendors, and employees--is also critical. 14. We evaluate the capacity for repayment at emergence (what we refer to as our CRE analysis) by focusing on fundamental aspects of both the debtor's credit profile and the DIP obligation. We assess not only if the debtor is likely to emerge from bankruptcy but also whether it is likely that the DIP obligation could be repaid in full at the point of emergence. The CRE assessment, as shown in the table, focuses on four key factors: What the bankruptcy triggers were and restructuring needs are; Business risk profile and operating outlook; Liquidity and free cash flow prospects; and Target going concern coverage assessment. 15. The going concern coverage assessment measures the extent to which the DIP obligation, along with any priority and pari passu claims, would be covered by our estimate of the debtor's going concern value. (The calculation of the going concern coverage ratio is the projected enterprise value at emergence divided by estimated DIP claims plus any priority or pari passu claims.) When there are multiple DIP instruments that have different payment or collateral priorities, we assess each DIP tranche separately. For this calculation, we do not necessarily assume that the DIP obligation will be fully drawn up to the maximum committed amount because in a reorganization scenario, we would generally expect there to be some excess liquidity. 16. Our analysis of these factors results in a CRE assessment for each DIP obligation that conveys our overall view of the relative capacity for repayment in full at emergence as either limited, moderate, high, or very high risk. The highest rating possible from the CRE analysis, before considering potential enhancement for full coverage in a liquidation scenario, is 'BBB+'. The table below describes these CRE and risk factors. Capacity For Full Repayment At Emergence (CRE) : Indicative Characteristics By Risk Category TYPICAL BUSINESS, FINANCIAL, AND LOAN ATTRIBUTES GENERALLY ASSOCIATED WITH EACH CRE RISK PROFILE * LIMITED RISK ('BBB' CATEGORY) Excess leverage or an external shock was the primary default trigger; a straightforward debt restructuring is the primary need The prospective business risk profile must be at least fair, and the operating outlook should be generally favorable due to debtor's competitive position, industry fundamentals, or both Liquidity (including cash flow) is sufficient to fund cash needs during reorganization with a cushion of at least 20% Target going concern coverage ratio of approximately 3x or higher, meaning the DIP loan is no more than ome-third of our estimate of the debtor's enterprise value after accounting for higher-priority and pari passu claims MODERATE RISK ('BB' CATEGORY) Default triggers likely included leverage and operational problems; the restructuring may include moderate but manageable complications due to various operational restructuring needs or a somewhat more complex debt, liability, or organizational structure Competitive position, industry, or both under some stress Free cash flow prospects are positive, though there might be some uncertainty, weakness, or mild deficits in the near term. Nevertheless, liquidity appears sufficient, and there is some cushion for unforeseen developments Target going concern coverage ratio of approximately 1.5x or higher, meaning the DIP loan is no more than two-thirds of our estimate of the debtor's enterprise value after accounting for higher-priority and pari passu claims HIGH RISK ('B' CATEGORY) Operating problems were a significant contributor to default/distress; the required restructuring could be complex, which could hinder the debtor's ability to effectively resolve its problems or reorganize Fragile competitive position, industry fundamentals, or both Free cash flow prospects are uncertain, weak, or negative, or liquidity could be tight, with limited cushion for unforeseen developments Target going concern coverage ratio of at least 1x, meaning the DIP loan is at least fully covered by our estimate of the debtor's enterprise value after accounting for higher-priority and pari passu claims VERY HIGH RISK ('CCC' CATEGORY) Our analysis of a DIP loan includes a going concern coverage ratio of less than 1x, meaning there is a strong possibililtythat the debtor's going concern value will be insufficient to fully cover the DIP loan after accounting for higher priority and pari passu claims *The highest rating possible from the CRE analysis, before considering potential enhancement for full coverage in a liquidation scenario, is 'BBB+'. In rating DIP financings, we generally use the business and financial attributes listed for each CRE risk profile category. Typically, we will assign a CRE based on the key drivers as described above. For example, in some cases, relative strengths in one factor will offset weaknesses in another, while in other situations certain risk factors will dominate our conclusion. However, an entity must typically meet the target going concern coverage ratios for each risk profile category. Assessments viewed at the higher end of each risk profile characterization would receive a plus to the category rating, and those at the lower end would receive a minus to the category rating. 17. An important difference between a DIP transaction and another rated instrument is the former's relatively short time horizon (generally less than two years). Accordingly, our analysis focuses on near- to intermediate-term expectations and the expected levels of competitive and economic stresses. In rating a DIP obligation, we focus on longer-range factors only to the extent that they affect the company's ability to reorganize and attract sufficient new capital to fully repay the DIP obligation at emergence. 18. Once the company has filed for Chapter 11 protection, pre-petition debt service usually is suspended. Obviously, there will be debt service on the DIP obligation, and there could be other obligations the court has approved for continuing payment. If there is pre-petition secured debt, the company generally will accrue post-petition interest--even if no cash payments are being made--to the extent the value of the security exceeds the amount of the debt. It is imperative to be aware of any motions that may be filed on behalf of pre-petition creditors to receive payment of their claims, adequate protection for their position, or otherwise contest the DIP obligation. In addition, the company may be planning asset sales, store closings, or lease cancellations, all of which could have a bearing on the level of cash flow the company can generate and its attractiveness as a viable candidate for fresh financing to take out the DIP lenders. Collateral, legal protections, and ultimate recovery in a liquidation scenario 19. The second part of the DIP rating analysis looks at the specifics of the DIP obligation and its potential for full recovery in the event of liquidation. This scenario could involve an outright asset liquidation under Chapter 7 or Chapter 11 of the U.S. Bankruptcy Code or a forced sale of the business (under extremely distressed conditions), depending on our view of the business's viability and its reorganization challenges. DIP obligations that we assume are sufficiently overcollateralized to be fully repaid under our liquidation scenario may benefit from a one- or two-notch enhancement over the rating indicated by the CRE assessment, depending on our estimated level of coverage and our confidence in full repayment. We would only apply a two-notch enhancement if significant overcollateralization, strong structural features, or both were to give us very high confidence in full recovery. In any event, this part of our analysis contemplates a downside valuation consistent with circumstances that would preclude the company from reorganizing. We will also generally assume a higher DIP claim, as excess liquidity would be exhausted in the failed attempt to reorganize. 20. We analyze collateral with a focus on its ability to retain value through liquidation. A conservative valuation of the collateral should cover the obligation by a safe margin. 21. Section 364 of the U.S. Bankruptcy Code provides for "superpriority" status to be given to a claim for payments on the DIP obligation if that is the only way to induce lenders to provide credit. Superpriority status--i.e., the right to demand full cash repayment at emergence from bankruptcy--limits the risk that DIP lenders will have ongoing credit exposure to the reorganized firm, the capital structure and leverage of which are unknown. This protection, along with liens on unencumbered property and priming (superseding) liens on encumbered property, is usually provided to DIP lenders. Such protections are generally granted and binding by court order. The nature and extent of court-ordered protections like these are an important consideration in these criteria. 22. By providing clarity on the status of the lender's claim to be repaid, court orders authorizing application of these provisions of the bankruptcy code give substantial comfort. Analysis of the financing agreement and court orders can determine the priority of the lender's claim on the company's payments. It is important to review any other claims that are either on par with or senior to the DIP obligation. In addition, there could be liens--such as taxes and ERISA--that can affect the lender's claim. Pension Benefit Guaranty Corp. (PBGC) claims normally are treated as junior in priority to any DIP claim. 23. A DIP obligation with superpriority claim status--as well as a tight financing agreement and court order--can get the full measure of rating enhancement. A strong court order would state that no other claim having priority over or being on par with the DIP obligation should be granted while the DIP obligation is outstanding. This is important because the lender might have a security interest in unencumbered collateral. In addition, the court order should explicitly establish the superpriority status of the DIP lender's claim and assure that the automatic stay provisions will not be lifted or modified to the detriment of the DIP obligation. REVISIONS AND UPDATES EFFECTIVE DATE AND TRANSITION These criteria became effective on the date of publication. This article is related to our global corporate criteria (see "Corporate Methodology," published on Nov. 19, 2013) and to the article "Update On Rating Methodology For Debtor-In-Possession Loans With Noncash Pay Features," published on July 30, 2009. RELATED CRITERIA AND RESEARCH Related Criteria Corporate Methodology, Nov. 19, 2013 Update On Rating Methodology For Debtor-In-Possession Loans With Noncash Pay Features, July 30, 2009