Examination Bulletin: FCA 2009-1
Subject: Debtor-In-Possession Financing

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PURPOSE

This bulletin provides Farm Credit Administration (FCA) examiners guidance for evaluating Farm Credit System (System) institutions' extension of Debtor-In-Possession financing--with specific attention to compliance with FCA's regulations covering the "rule of aggregation" and performance status.

INTRODUCTION

Debtor-In-Possession (DIP) financing is extended to a borrower after it files a Chapter 11 (reorganization) bankruptcy petition. In a Chapter 11 bankruptcy case, a debtor ordinarily continues in possession of its property and operates its business as a "debtor-in-possession." DIP financing is unique from other financing methods because the bankruptcy court has authority to grant the DIP lender priority over existing debts, a lien on unencumbered property, or a senior, equal, or junior lien on encumbered property (provided the existing lien holders' interests are adequately protected).

EXAMINATION GUIDANCE

Controlling Risk in DIP Financing

Strict asset-based lending controls and monitoring are central to DIP risk management. Although some larger commercial banks have special DIP financing units, many lenders provide such financing through Accounts Receivable and Inventory Financing (ARIF) units. DIP financing must be properly structured, documented, and administered. If it is, and because of the protections afforded by bankruptcy laws, some lenders contend DIP financing does not necessarily pose greater risk than conventional ARIF. Importantly, DIP financing can help protect the value of the collateral by allowing the bankrupt business to continue as a going concern.

Before engaging in this type of financing, an institution should ensure that its asset-based lending procedures and expertise are sufficient to conduct this lending activity in a safe and sound manner. The institution should seek the guidance and representation of an experienced bankruptcy attorney to help evaluate the debtor's ability to successfully reorganize and to protect the institution's position in the event the reorganization fails. Lenders who do not participate in DIP financing should also continually monitor and evaluate their position in the debtor's bankruptcy proceeding to ensure that their security interests are adequately protected.

Application of the "Rule of Aggregation"

DIP financing may be viewed as an independent credit risk under FCA Regulation § 621.7 (See Attachment 1). Since the bankruptcy court approves these loans and treats the post-bankruptcy petition DIP as a separate entity apart from the pre-petition debtor, the court's involvement essentially results in a different obligor for the purposes of applying the regulatory criteria for an independent credit risk. These loans are also generally structured with super-priority status over other creditors. While this superior claim may be on the same cash flow or collateral securing other loans, the additional legal protections provided to lenders under this loan structure typically are sufficient to separate the primary sources of repayment and collateral from those of the pre-bankruptcy loan obligations—thus, creating a separate and non-aggregated credit risk. Nonetheless, FCA examiners are not precluded from requiring an institution to apply the rule of aggregation if the institution has not sufficiently protected its position with regard to the DIP financing arrangement. Examiners should expect to see a documented analysis of the DIP financing decision and application of the rule of aggregation.

Assigning Performance Status, Credit Classifications, and Risk Ratings

Even though DIP financing may represent an independent credit risk under the criteria established by FCA Regulation § 621.7, bankruptcy inherently presents increased risks to an institution. As such, we would expect the institution to carefully evaluate the performance status of all exposures to such borrowers in accordance with FCA Regulation § 621.6 (see Attachment 2). Likewise, because risk in DIP financing can vary, we expect institutions to thoroughly analyze DIP loans and assign appropriate credit classifications and risk ratings. For example, when DIP financing is provided to an operating business, which is continuing to produce and sell its product, the risk is less than DIP financing provided for protective advances to a business no longer operating and selling product. As such, examiners should ensure the institution's performance status, credit classifications, and risk ratings continually reflect the current situation on DIP financing arrangements.

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Attachment 1

PART 621 - ACCOUNTING AND REPORTING REQUIREMENTS
Subpart C - Loan Performance and Valuation Assessment

§ 621.7 Rule of aggregation.

(a) When one loan to a borrower is placed in nonaccrual, an institution must immediately evaluate whether its other loans to that borrower, or related borrowers, should also be placed in nonaccrual. All loans on which a borrowing entity, or a component of a borrowing entity, is primarily obligated to the reporting institution shall be considered as one loan unless a review of all pertinent facts supports a reasonable determination that a particular loan constitutes an independent credit risk and such determination is adequately documented in the loan file.

(1) A loan shall be considered an independent credit risk if a substantial portion of the loan is guaranteed as to principal and interest by a government agency.

(2) Other loans shall be considered independent credit risks if and so long as:

(i) The primary sources of repayment are independent for each loan;

(ii) The loans are not cross-collateralized; and

(iii) The principal obligors are different person(s) and/or entity(ies). Related loans will not be considered independent credit risks if the operations of a related borrower are so financially interdependent with the borrower's operations that the economic survival of one will materially affect the economic survival of the other, determined in accordance with § 614.4359(a)(2) of this chapter.

(b) If the evaluation required by paragraph (a) of this section results in a determination that the borrower's other loans with the institution do not represent an independent credit risk, and full collection of such loans is not expected, then all of the borrower's loans must be aggregated and classified as nonaccrual. If such other loans represent an independent credit risk and are fully collectible, then they may remain in their current performance category.

(c) When an institution becomes aware that a borrower has a loan that has been classified nonaccrual by any other lender, the institution must reevaluate the credit risk in its loan to the borrower and then determine whether an independent credit risk exists.

Attachment 2

PART 621 - ACCOUNTING AND REPORTING REQUIREMENTS
Subpart C - Loan Performance and Valuation Assessment

§ 621.6 Performance categories and other property owned.

Each institution shall employ the following practices with respect to categorizing high-risk loans and loan-related assets. No loan shall be put into more than one performance category. At a minimum, loans meeting the criteria for both nonaccrual and another performance category shall be classified as nonaccrual.

(a) *Nonaccrual loans.* A loan shall be considered nonaccrual if it meets any of the following conditions:

(1) Collection of any amount of outstanding principal and all past and future interest accruals, considered over the full term of the asset, is not expected;

(2) Any portion of the loan has been charged off, except in cases where the prior chargeoff was taken as part of a formal restructuring of the loan; or

(3) The loan is 90 days past due and is not both adequately secured and in process of collection.

(i) A loan is considered adequately secured only if:

(A) It is secured by real or personal property having a net realizable value sufficient to discharge the debt in full; or

(B) It is guaranteed by a financially responsible party in an amount sufficient to discharge the debt in full.

(ii) A loan is considered in process of collection only if collection efforts are proceeding in due course and, based on a probable and specific event, are expected to result in the prompt repayment of the debt or its restoration to current status. There must be documented evidence that collection in full of amounts due and unpaid is expected to occur within a reasonable time period, not to exceed 180 days from the date that payment was due. The commencement of collection efforts through legal action, including bankruptcy or foreclosure, or through collection efforts not involving legal action, including ongoing workouts and reamortizations, do not, in and of themselves, provide sufficient cause to keep a loan out of nonaccrual status. If full collection of the debt or its restoration to current status is dependent upon completion of any action by the borrower, the institution must obtain the borrower's written agreement to complete all such actions by the specific dates set forth in agreement.

(b) *Formally restructured loans.* A loan is considered formally restructured if it meets the "troubled debt restructuring" definition set forth in Statement of Financial Accounting Standards No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, as promulgated by the FASB.

(c) *Loans 90 days past due still accruing interest.*

(1) Loans 90 days past due still accruing interest means loans that are 90 days or more contractually past due, and that are both adequately secured and in process of collection, as described in this section.

(2) A loan shall be considered contractually past due when any principal repayment or interest payment required by the loan instrument is not received on or before the due date. A loan shall remain contractually past due until it is formally restructured or until the entire amount past due, including principal, accrued interest, and penalty interest incurred as the result of past due status, is collected or otherwise discharged in full.

(d) *Other property owned* means any real or personal property, other than an interest-earning asset, that has been acquired as a result of full or partial liquidation of a loan, through foreclosure, deed in lieu of foreclosure, or other means.