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FINANCIAL RESTRUCTURE FOR BUSINESSES AND GOVERNMENTS

PROVIDING CAPITAL TO A CHAPTER 11 COMPANY

Lending To, Buying From And Providing Exit Financing To A Debtor-in-Possession

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Executive Summary

This outline describes opportunities for a capital provider to lend to, buy from and provide equity or debt exit financing to a Chapter 11 debtor.

When a company is troubled, it often has a hard time borrowing more money, selling assets and selling new equity investments. The Bankruptcy Code facilitates each of these and provides opportunities for a capital provider to help preserve the company's going concern and to acquire it.

This process often begins with a loan to the company as a Chapter 11 debtor in possession (a "DIP loan") that must be paid back in full in cash upon confirmation of a Chapter 11 plan for the debtor. However, a DIP lender can also use it to credit bid in a sale of the debtor's assets or agree to convert it to equity in a plan of reorganization for the debtor.

In addition, DIP lenders receive access to a tremendous amount of information during a Chapter 11 case. All this gives them significant influence during the case and permits them to make an informed decision about how to use their DIP loan at the end of the case.

This outline describes how the Chapter 11 process provides these opportunities to lend to, buy from or make exit equity investments in a Chapter 11 debtor.

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I. When a company has liquidity/solvency problems, it becomes more difficult to raise new capital to solve the problem.

A. The three basic ways to raise more money are:

1. Borrow more money secured by the company's assets.

2. Sell some of the company's assets.

3. Sell new equity interests.

B. In a liquidity/solvency crisis, it is:

1. Difficult to borrow more money.

   a. Many lenders are concerned about preference and fraudulent conveyance issues if the company later files bankruptcy.

   b. Many existing lenders will not consent to liens junior to themselves; they certainly will not agree to liens senior to themselves.

   c. Many lenders would actually rather lend to a Chapter 11 debtor, where they get a court order blessing their liens and loans, rather than lend to a company they consider troubled.

2. Difficult to sell assets.

   a. Purchasers want solvency opinions to avoid claims that their purchase was a fraudulent conveyance (a transfer made while insolvent for less than fair consideration that is potentially reversible by later legal action).

   b. Purchasers are wary of liabilities that might attach to the assets that they buy from a troubled company, particularly unknown liabilities.

3. Difficult to raise new equity investments.

   a. Potential equity investors want to see a cleaner balance sheet with less debt, especially less contingent debt.

   b. Equity has a low priority if there is a subsequent bankruptcy. As a result, many potential equity investors seek a "debt piece" as part

of their investment to have some priority in a possible future bankruptcy.

C. The Bankruptcy Code makes it easier for a company in a Chapter 11 case (a "Debtor") to do all three of these things: (i) borrow money; (ii) sell assets; and (iii) raise new equity investments.

II. Understanding the company side of the deal – What is the reorganization challenge that a Chapter 11 debtor is dealing with?

A. If an investor wants to provide capital to a Chapter 11 debtor by loan, asset purchase or exit financing, it is helpful to understand the context in which the debtor functions.

B. The officers and board of directors of a company going through reorganization have a fiduciary duty to preserve and maximize its going concern value and to allocate that value fairly among creditors and old equity security holders (if there is sufficient value for them). If a company's officers and directors choose to pursue those goals through a Chapter 11 case, they will eventually have to decide which of three basic kinds of a plan of reorganization to propose.

1. A Stand Alone Plan, changing the terms of secured debt and converting some or all unsecured debt to equity, with no new investment at consummation of the plan, premised on adequate existing capital to run the company's business after its debt has been restructured, and sufficient enterprise value to pay unsecured creditors more than in liquidation, possibly enough to pay them in full thus leaving some value for old equity (a **"Stand Alone Plan"**).

   a. The crucial question here is whether the debtor already has adequate capital once its debts are restructured.

2. A Stand Alone Plan, changing the terms of secured debt and converting some unsecured debt to equity, with a new investment at consummation made by a third party (or by old lenders or shareholders) that essentially buys the majority new equity in the reorganized company (a **"Stand Alone New Value Plan"**).

   a. The crucial question here is whether a new investor can be found willing to invest essential new capital in the debtor's business plan once its debts are restructured and what terms it wants for its investment.

3. A plan to sell the assets of the company as a going concern free and clear of liens, with liens to attach to proceeds, and proceeds to be allocated to creditors according to the priority of their claims (a **"Sale Plan"**).

a. Such a plan ends the company's existence, but preserves the company's going concern value and many of the jobs the company had been supporting, and purchasers often offer equity incentives to managers.

b. The crucial question is whether a purchaser can be found.

4. A plan to merge the company with other debtors to create a larger, more efficient company better able to compete in the relevant market (**"Consolidation Plan"**).

5. It is helpful to have these basic options in mind when deciding how to structure the provision of capital to a Chapter 11 company.

III. Companies file bankruptcy cases primarily to refinance through loans, sales and exit financings, presenting opportunities to capital providers.

A. The "common wisdom" is that companies file a Chapter 11 case (i) to take advantage of the automatic stay to avoid paying pre-petition debts on a current basis during the case and (ii) to take advantage of the aggressive things that can be done at the end of the case to restructure secured and unsecured debt through a plan.

1. The Bankruptcy Codes gives (i) relief to current cash needs during the case and (ii) the power to forcibly change existing debt structure at the end of the case.

2. During the Chapter 11 case, the debtor obtains cash relief because:

a. It makes no current payment of pre-petition unsecured debt;

b. It makes no current payment of pre-petition secured debt, as long as the secured claim is "adequately protected";

c. It makes only current payment for post-petition accruals on contracts; and

d. It can reject unfavorable contracts, creating an unsecured rejection damage claim that can be dealt with in a plan at the end of the case.

3. In a plan at the end of a Chapter 11 case, the debtor has the power, among other things, to:

a. Forcibly change the terms of existing secured loans (by extending their maturity, changing the amount of periodic payments, and changing the rate of interest); and

b. Forcibly convert unsecured debt to equity.

4. These forcible changes are done based on proof of feasibility and valuation.

a. This proof is made to the Bankruptcy Court through expert witness testimony and cross-examination.

b. The Bankruptcy Court makes findings of fact based on this expert testimony that are often difficult to overturn on appeal.

B. The primary reasons for a Chapter 11 filing are often different from the "common wisdom."

1. **Major companies avoid bankruptcy as long as possible to protect their shareholders' interests rather than dive in to go on offense to change the terms of their debt.**

a. This might not be true in the rare case where a company has covenant defaults with its lenders but a large enterprise value so that creditors can be paid in full over time with value left for old equity.

2. **They file because illiquidity/insolvency can be an intensely difficult environment with multiple conflicting duties and, after a while in restructure negotiations, it becomes safer to have a Bankruptcy Code to follow and a Bankruptcy Court to approve major business judgments.**

3. **They file primarily because they have liquidity/solvency problems leading to a need to refinance that they cannot solve adequately outside of bankruptcy, and they can use the Bankruptcy Code to facilitate refinancing.**

4. **This presents an opportunity for a new capital provider who wants to own the company or its assets.**

IV. The Bankruptcy Code facilitates lending to a Chapter 11 debtor (§ 364).

A. This is usually done early in the case, often based on pre-bankruptcy loan negotiations with the existing lender.

B. Under Section 364(a), the debtor can obtain in the ordinary course of business without Court approval, unsecured credit with a general administrative priority.

C. Under Section 364(b), the debtor can obtain outside the ordinary course of business with approval of the bankruptcy court presiding over the debtor's case (the "Court"), unsecured credit with a general administrative priority. Few lenders will be willing to extend unsecured credit to a company in bankruptcy.

D. Under Section 364(c), a new loan to a Chapter 11 debtor in possession (a "DIP loan") can be:

1. Secured by property not previously encumbered by a lien; or

2. Secured by a **junior lien** on property that is already subject to a lien, even if the existing lien prohibits junior liens.

3. To order a junior lien, the existing lienholder need not be proven to be adequately protected.

E. Under Section 364(d), a new loan can be:

1. Secured by a **senior or equal lien** on property that is already subject to a lien.

a. To do this kind of a "priming" lien, the debtor must prove, and the Court must find, that the pre-existing lien holder is adequately protected even if this new lien claim is put ahead of it.

b. These priming/adequate protection hearings:

(i) Are essentially trials about the value of the assets that are subject to lien.

(ii) Are very difficult; pre-petition lenders dislike them intensely and only a few lenders are willing to act aggressively toward old lenders by seeking a priming position.

F. For loans under both § 364(c) and (d), the lender can be given a superpriority for any unsecured deficiency claim that might result after collection on the collateral, with a priority higher than any other post-bankruptcy expenses of administering the bankruptcy case.

1. A DIP loan with this superpriority status must be paid in cash in full at the end of the Chapter 11 case.

a. It cannot be extended beyond the end of the Chapter 11 case without the lender's consent.

b. This gives the DIP lender tremendous power at the end of the Chapter 11 case.

c. A DIP lender can exercise its power flexibly by:

(i) using its DIP loan to credit bid in a sale of its collateral; or

(ii) converting its DIP loan to equity if the debtor offers to do that pursuant to a plan of reorganization (a "Plan").

d. But a DIP lender can also demand to be paid cash in full on consummation of a plan of reorganization.

2. During the bankruptcy case, a DIP lender receives substantial cash flow information concerning the debtor, which facilitates its assessment of whether it wishes to accept a different treatment of its claim by credit bidding or agreeing to convert some, or all, of its debt to equity at the end of the bankruptcy case.

G. If a DIP loan is approved (and not stayed pending appeal), appellate challenges to the order approving it can be dismissed for "mootness." Section 364(e) of the Bankruptcy Code provides that if a DIP lender extended credit in good faith, then:

1. The reversal of the lending order on appeal does not affect the validity of (a) the debt, (b) the lien or (c) the priority (for any deficiency claim on the loan) that was granted in the order approving the loan.

2. This is true even if the DIP lender knew of the pendency of the appeal when it closed the loan and advanced money in reliance on the court order, as long as the order had not been stayed pending appeal.

V. The Bankruptcy Code facilitates buying from a Chapter 11 debtor (§ 363).

A. Offers to sell are not binding on the debtor until the Court approves the sale.

1. For purchasers accustomed to non-bankruptcy sale transactions in which the sale contract is enforceable against the seller upon signing, this fact is a major departure from regular practice.

2. Many purchasers have come to Court, only to be outbid by another bidder who used the contract that the purchaser spent money to due diligence, draft and negotiate, and then bid slightly higher to win the sale.

3. As a result, a fairly standard auction sale procedure has arisen. A proposed asset purchaser will:

a. Sign a purchase contract with the debtor, subject to Court approval;

b. Put up a deposit;

c. Require the debtor to obtain early approval of a "break-up fee" and bid procedures;

d. Agree to auction procedures, typically providing for credit bid rights for any secured creditors with liens on the assets to be sold;

(i) There is often controversy about whether the assets should be sold as a whole, in separate groups or individually.

(ii) This can lead to controversy about how credit bidding will work.

e. The debtor then solicits other bids, picks qualified bids (based on financial capability and other relevant criteria) and conducts an auction among qualified bidders according to the approved bid procedures;

f. If the initial bidder does not win in the auction, then the debtor pays the approved break-up fee.

g. Assuming that the debtor follows the pre-approved bid procedures, there should not be much controversy in Court.

h. In fact, there is often still controversy at the hearing to approve the winner of the auction.

B. The reason to endure this cumbersome sales procedure is that:

1. The buyer can obtain the cleanest possible title to the assets acquired by a sale free and clear of any "interest" in such property.

a. "Interest" certainly means a lien.

b. Does "interest" mean a claim?

(i) A claim under the labor laws?

(ii) A claim under the environmental laws?

(iii) A claim under the ERISA laws?

c. What is a claim?

(i) Matured claims.

(ii) Contingent claims.

d. It is important what the proposed sale order says about precisely what interests and claims the assets are being sold free and clear of.

(i) The concept of res judicata applies to sales under Section 363.

(ii) If the order approving the debtor's motion to sell says that an asset is to be sold free and clear of an interest and the claimant gets notice and does not object, then the asset will be sold free and clear of that interest, even if the law does not otherwise support that.

e. It is important who gets notice of the proposed order approving a sale.

(i) Assets cannot be sold free and clear of a claim of someone who did not get notice.

(ii) Notice can be direct written notice.

(iii) In some cases, notice can be publication notice.

f. Section 363(k) provides that, if assets are to be sold free and clear of the lien of a secured creditor, the secured creditor has a right to "credit bid" in that sale.

(i) Section 363(k) should apply to DIP lenders as well as pre-petition lenders.

2. If the buyer is the so-called "stalking horse" bidder who has been given a breakup fee pursuant to a bid procedures order, it will be paid that fee if it loses, at least recovering its expenses, sometimes recovering additional amounts.

3. If a sale is approved to a good-faith purchaser and then consummated, appellate challenges to the sale can be dismissed for "mootness."

a. Section 363(m) of the Bankruptcy Code provides that, "the reversal or modification on appeal" of [the order approving the sale]…does not affect the validity of the sale…"

C. It is also possible for a Court to approve a non-auction, private sale of assets.

1. Where there has been an extensive pre-bankruptcy sale process and there is evidence that no additional bidders are likely to appear.

2. Or, if the assets to be sold are "spoiling" and will lose value if not sold quickly without an extensive sale process.

VI. The Bankruptcy Code facilitates providing equity to a Chapter 11 debtor through exit financing (§§ 1123, 1129)

A. **A debtor can offer in a plan of reorganization (a "Plan") a percentage of the stock in the reorganized company to a new investor who brings in new money to re-capitalize the company ("Exit Financing").**

B. **The debtor, or any other plan proponent, cannot unilaterally close a deal for a new equity investment.**

1. The debtor can agree in writing to sell a percentage of the stock in the reorganized company in exchange for a new equity investment, but it cannot consummate that deal except upon confirmation of its plan by Court order after a hearing.

2. Confirming a plan can be more time consuming and difficult than running an auction sale of assets pursuant to Section 363 as described above.

3. As a result, new equity investors generally ask for breakup fee and bid procedure protections at least as detailed as those described above for asset purchasers.

C. **In negotiations with a plan proponent, the new equity investor can ask for:**

1. Substantive provisions:

a. The new investor can dictate what capital structure the debtor must bring to it in the plan, or walk away.

(i) For example, "I will only invest if (a) the maturity of the secured debt is extended 50%, (b) all unsecured debt is converted to 49% of the equity in the Company, and (c) I receive 51% of the equity on account of my new investment."

b. A DIP lender may provide exit financing in the form of a combination of an additional cash infusion upon the consummation of the plan and/or the conversion of some or all of its existing DIP loan to equity.

2. Procedural protections:

a. Set a date by which the plan must be confirmed.

b. Describe procedures for any auction of the new investment opportunity.

c. Obtain a breakup fee to compensate for the expense of pursuing the investment if it is not consummated.

(i) This should include the bidder's expenses.

(ii) This might include opportunity cost.

d. Provide whether the investor will close on the new investment upon entry of a plan confirmation order (as long as no stay is in place), or only after appeals are completed and the order is "final."

(i) Although it is not written into the Bankruptcy Code, courts have applied the mootness concept to plan confirmations the same as with sales and loans.

(ii) Thus, if there is no stay pending appeal and the plan is consummated (including the making of equity investments), appeals of the plan confirmation order can be dismissed for mootness.

(iii) This leads to a negotiation between:

(a) The debtor's "I don't want a non-courageous investor who won't close in the face of an appeal," versus

(b) The investor's "I want the right to demand a final order; I can always waive it if the situation feels right."

D. With whom does the potential new investor negotiate?

1. Assuming the debtor still has the exclusive right to file a plan, the debtor (existing management) will negotiate the new investment.

a. Existing management may wish to obtain a percentage of the equity of the reorganized debtor. This might be approved by the Court if this interest is to be earned based on future performance.

b. The existing shareholders may also wish to negotiate to preserve their interests in the debtor by receiving a percentage of stock in the reorganized Company.

c. However, as noted above, unless all creditors are paid 100% of their claims, the existing shareholders are prohibited from receiving any value on account of their old equity interests.

2. To avoid loss of their equity interest, existing shareholders may seek to invest additional funds ("New Value") upon consummation of the debtor's plan.

a. While the Bankruptcy Code does not prohibit an existing equity owner from participating in a New Value Plan, the Supreme Court held in LaSalle that, before such a plan proposed through officers influenced by old equity owners can be approved, there must be a "market test" of the plan, meaning that (i) the shareholders' proposed new equity investment could be opened up to competitive bidding or (ii) the debtor's exclusive right to file a plan could be terminated.

3. If the debtor has lost its exclusive right to file a plan (either because the debtor has been unable to propose a plan within the time provided by the Bankruptcy Code, or for other cause), then the new investor can negotiate with the debtor, or any other party in interest who wants to propose a plan, including creditors, shareholders or a committee of creditors or shareholders.

a. Sometimes a party who wants to terminate exclusivity will get an investor lined up to support the plan that it would file if exclusivity were terminated.

4. A new investor will likely encounter complex negotiations with a number of parties who have conflicting viewpoints about value and the need for the new investment.

a. The debtor (essentially management) often wants a new investment to make its plan feasible and to make the reorganized company valuable enough to leave something for its old shareholders.

b. The pre-petition unsecured creditors often think that the reorganized company will be worth so little that, even with the new

investment, unsecured creditors must receive 100% of the stock of the reorganized company to come anywhere close to being paid in full.

c. The old shareholders often think that: (i) the company is worth a lot, so that only a small percentage of the company's stock is necessary to pay unsecured creditors in full, with old equity receiving the remainder; and (ii) the new investment will not add that much value, so the reorganized company should not give away too much equity for this new investment.

5. The new investor holds the gold and can demand the rules it wishes to allocate value among these different parties, or walk away.

E. **Once the new equity investor reaches a deal to invest upon confirmation and consummation of a plan, it is then along for the ride as the plan proponent (presumably the debtor) tries to confirm the plan, with the option to walk away if things do not go as expected, or to re-negotiate if it wants. This choice is presented repeatedly.**

1. There might be an agreed-upon auction of the right to make the equity investment.

2. Some important secured lender might want to negotiate, or else object to the plan.

3. The unsecured creditors committee might want to negotiate, or else object to the plan.

4. The old shareholders might want to negotiate, or else object to the plan.

5. The debtor could be subjected to burdensome discovery by plan objectors.

6. The debtor might begin a plan confirmation hearing in the face of any remaining objections to the plan and then ask the new equity investor to make a change to cause an objection to be withdrawn.

7. The debtor might obtain a plan confirmation order and ask the new investor to consummate the plan before any stay can be obtained, even though objectors might have taken an appeal.

8. Depending on the rights it has negotiated with the debtor, at every step along the way, the new investor can:

a. Stand pat and let the debtor take its chances;

b. Change its deal to help the debtor overcome an objection; or

c. Walk away from the deal because the debtor changed it to win over an objector, but the investor is not willing to accept the change and is no longer willing to go forward.

F. **Capital from a new investor is often crucial to whether a debtor can confirm a standalone plan of reorganization, or must sell its assets as a going concern.**

1. **To confirm a plan a debtor must prove three major economic points:**

a. That the plan pays creditors not less than they would receive in a liquidation under Chapter 7.

b. That the plan is feasible.

c. That all creditor classes have either (i) voted for the plan, or (ii) are being treated fairly and equitably.

(i) Fair and equitable treatment for secured claims means that:

(a) the secured creditor retains its lien and receives cash payments over time that have a present value, as of the effective date of the plan, equal to the amount of the secured claim (which is capped at the value of the collateral securing the claim);

(b) if its collateral is to be sold, the secured creditor should be permitted to credit bid at the sale and, if a cash bid wins, its liens will attach to cash proceeds; or

(c) the secured creditor will receive the "indubitable equivalent" of its secured claim (a broad term undefined in the Bankruptcy Code).

(ii) Fair and equitable treatment for unsecured claims means that they are given value equal to 100¢ on the dollar, or else the old equity holders cannot receive any value on account of their ownership interests. This value can come in essentially any form, including a combination of:

(a) Cash;

(b) Notes; or

(c) Stock (treasury stock or shares issued pursuant to the plan).

(1) The Bankruptcy Court values the stock, usually in a trial with expert testimony about cash flow projections, capitalization factors and discount rates.

(2) Such valuation findings are difficult to reverse on appeal.

2. **Adequate capital is important to proving all three of these major points.**

a. Adequate capital is necessary to support a going concern instead of a Chapter 7 liquidation.

b. Adequate capital is important to prove the feasibility of projections for a going concern business.

c. Adequate capital is important to prove the value of stock that might be used to pay unsecured creditors fairly and equitably under the plan.

3. **This is why a new investor can have so much influence over the terms of a debtor's plan.**