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## Navigating Today's Environment

# The Directors' and Officers' Guide to Restructuring

SECOND EDITION

**Michael Eisenband**
Consulting Editor
FTI Consulting

AMERICAN BANKRUPTCY INSTITUTE

# NAVIGATING TODAY'S ENVIRONMENT

## THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING

SECOND EDITION


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### Overview of Chapter 11 financing

Distressed companies often face the following challenge: having devised a plan to stabilize the company, restructure its operations and/or right-size its balance sheet, the company needs time and, thus, liquidity — which it may not have — to bridge the period through a turnaround. At the same time, lenders and other traditional sources of capital may be unwilling to provide new capital to the company outside of Chapter 11 given the circumstances and credit risk. For borrowers facing this dilemma, Chapter 11 offers two unique financing solutions.

First, companies with existing cash and a projected cash flow that is sufficient to fund a restructuring, but which has been pledged as collateral for an existing financing, can use the Bankruptcy Code to access this so-called "cash collateral." This cash collateral can be used as long as the company provides the holder of the security interest over the cash with "adequate protection" of the security interest. This adequate protection can be provided in a variety of forms including cash interest, replacement liens, payment of the lienholders' fees and expenses and claims in the bankruptcy case with priority over substantially all other claims. The amount of this adequate protection can either be agreed upon between the company and the lienholder or can be ordered by the court after a hearing.

Second, a company in Chapter 11 can obtain new post-filing (i.e., post-petition) debtor-in-possession ("DIP") financing. DIP financing typically takes the form of a post-petition loan offered to the debtor company to fund the company's operations in Chapter 11 as well as the costs associated with the Chapter 11 case, such as professional fees. While the credit support for a DIP facility varies on a case-by-case basis, a DIP lender typically receives some combination of liens over substantially all of the company's assets that are senior to all of the company's existing liens (the so-called "priming liens") as well as superpriority claims in the bankruptcy case, cash interest, and payment of lender fees and expenses.

DIP financing and the use of cash collateral are not mutually exclusive alternatives; in fact, they are often utilized in tandem. For example, a subset of lenders in a bank group may provide senior DIP financing in conjunction with the use of the full bank group's cash collateral. In another instance, if a lender with liens on cash collateral is unwilling or unable to extend DIP financing, the company may seek to use the lender's cash collateral concurrently with obtaining DIP financing from a new third party. Notably, the existing secured lender may be party to an intercreditor agreement or another arrangement with more junior lenders that may restrict or condition the junior lenders' ability to extend DIP financing. As these dynamics occur with frequency in complex Chapter 11 cases, it is important for a company to actively engage with secured lenders as part of the pre-petition planning process in an attempt to build as much consensus as possible going into Chapter 11.

## Obtaining DIP financing

Approval of DIP financing is typically sought in the first days of a Chapter 11 case to ease a company's transition into bankruptcy and ensure minimal operational disruptions. Usually the company seeks to obtain access to a portion of the total DIP loan (an interim amount) at the first-day hearing and then seeks further authority to borrow up to the full amount of the loan at a second-day hearing, typically held between 21 and 35 days into the bankruptcy case. Given this timeline for approval, the terms of DIP financing are often negotiated among the company, the DIP lender and the company's existing secured lenders during the weeks before the company files for bankruptcy. Given the central role of DIP financing in a Chapter 11 case, following the petition date, the company and the DIP lender will typically continue negotiating the terms of the DIP financing with any official committee of unsecured creditors (and any other court-appointed committees), the United States Trustee, and other key case constituents in order to resolve as many objections as possible.

When evaluating a debtor's request to obtain DIP financing, courts generally consider whether the terms of the DIP financing are fair and reasonable under the circumstances. In making this determination, courts will generally defer to a debtor's business judgment so long as the agreement to obtain such credit does not run afoul of the provisions of and policies underlying the Bankruptcy Code. Courts will also generally not require that the company obtain the best available or best hypothetically achievable terms but terms that are fair and reasonable given the circumstances. Against this backdrop and understanding that (a) companies negotiating for DIP financing often have limited leverage to demand more reasonable terms and (b) once approved, DIP financing becomes a critical element of any Chapter 11 case, creditors' committees, the United States Trustee and sometimes judges try to limit DIP lender influence and control by seeking to amend the terms of the proposed DIP financing. In addition to these post-petition negotiations and even after a company enters bankruptcy, offers for alternative DIP financing may be presented to the company, and a court may consider these alternative DIP financing proposals when evaluating a company's request for DIP financing approval.

As more fully described in the following section, a DIP loan provides the lender with an important voice in a company's Chapter 11 case. In addition to lucrative economics, the DIP loan often provides the lender with substantial control over the case (through milestones and other covenants) as well as other protections for, if applicable, any pre-petition claims the lender may have against the debtor. Thus, while there is no restriction on who may provide a DIP loan and third-party loans are not uncommon, DIP loans are often provided by a company's existing pre-bankruptcy creditors to protect their existing creditor positions — most often the secured lenders but also unsecured lenders.

Similarly, given their important role in a case, DIP loans are sometimes provided by the company's affiliates (including equity investors). In situations involving DIP financing provided by affiliated parties, courts will apply a higher level of scrutiny to ensure that affiliated parties are not exercising undue control of a Chapter 11 case through a DIP facility. When evaluating insider DIP facilities, courts generally look at whether independent directors or an independent committee of the company's board negotiated the terms of the DIP facility with the affiliated party and whether and to what extent alternative non-affiliated DIP financing was solicited, available and considered. For these reasons, companies in distressed situations often appoint independent directors with restructuring experience to navigate issues involving affiliates.

## The central role of DIP financing in Chapter 11 proceedings

DIP loans and the court orders and financing agreements that govern them tend to become critical parts of any Chapter 11 case. Given that distressed companies often face liquidity constraints, access to DIP financing (and related use of cash collateral) becomes the debtor company's lifeblood. DIP lenders typically negotiate protections in loan documents that provide them with significant influence in Chapter 11 proceedings. These provisions include:

— **Case milestones**: Case milestones represent deadlines by which debtor companies must take certain actions in a Chapter 11 case. These typically include deadlines to obtain court approval of the DIP facility (both on an interim and final basis); deadlines related to any sale processes contemplated by the company, deadlines for the filing, solicitation, and confirmation of the company's reorganization plan and an outside/maturity date by which the company must exit Chapter 11 and repay or otherwise satisfy the DIP loan.

— **The DIP budget**: The company and the DIP lender agree to a budget, setting forth the projected operational and restructuring costs to be incurred and paid during the Chapter 11 case. These budgets vary in length but typically cover a 13-week period and are detailed by week.

— **Events of default**: DIP loan documents typically contain provisions allowing DIP lenders to terminate the DIP, demand repayment and exercise remedies if, among other things, a trustee or examiner is appointed; a company breaches its representations, warranties or covenants; claims are pursued against the DIP lender or the DIP budget or case milestones are breached.

— **Credit bidding rights**: The Bankruptcy Code permits secured lenders to credit bid their debt in any bankruptcy sale of their collateral. This means that a DIP lender, instead of paying cash for its collateral, can purchase the collateral by deeming all or a portion of the DIP loan satisfied. DIP lenders typically negotiate for credit bidding rights that are senior to all other existing secured lenders.

DIP facilities that are provided by incumbent secured lenders may also include a feature called a "roll up." In a roll-up DIP, the company borrows (or is deemed to borrow) funds under the DIP facility and repays (or is deemed to repay) pre-petition debt with the borrowed funds, thus "rolling" the pre-petition debt into the post-petition debt. The lender benefits from the roll up because the Bankruptcy Code provides enhanced treatment and protections for post-petition DIP loans compared to pre-petition secured debt. The Bankruptcy Code provides that pre-bankruptcy secured lenders may be provided with cash equal to the value of their collateral (or replacement debt with an extended maturity and different interest rate and other terms) so long as the deferred cash payments under the new debt have a present value equal to the value of their collateral. Conversely, holders of DIP obligations (which constitute superpriority administrative expenses in the company's bankruptcy) must be paid in full in cash in order for the company to confirm a reorganization plan unless the DIP lender agrees otherwise.

In light of the influence that DIP financing provides the DIP lender over a Chapter 11 case, it is critical for directors and officers of distressed companies to negotiate a DIP financing package thoroughly and extensively. Ideally, a DIP facility will provide a balance of a sufficient financial commitment to enable the company to execute on its restructuring goals without so many covenants and restrictions that the company is effectively handcuffed. While lenders will likely insist on some or all of the previously described protections, negotiating these provisions to maintain maximum flexibility is key for a company's pursuit of a successful restructuring strategy. Additionally, while distressed companies may have limited negotiating leverage outside of Chapter 11, once the company enters Chapter 11 and the company's reorganization process builds steam, the DIP lender's ability to call a default and enforce the DIP protections may, to some extent, be practically limited or influenced by circumstances, the bankruptcy court and other participants in the bankruptcy case.

## Shifting dynamics in DIP financing

As directors and officers navigate DIP financing issues, it is critical to ensure that they and their advisors are fully apprised of the latest developments in DIP financing. As an initial matter, the proliferation of distressed investing and the increased competition in the high-yield debt market have driven new lenders into the DIP space. Historically, DIP loans were almost exclusively provided by a company's senior secured lender (typically a bank or a syndicate of banks). However, in recent years, distressed investors have been drawn to DIP financing for a number of compelling reasons. First, DIP lending is lucrative and secure. DIP lenders are generally able to charge higher interest rates than those for non-DIP loans of similar amounts and duration, while having the security of first-priority liens and superpriority claims approved by the bankruptcy court. Second, DIP facilities (particularly larger DIP facilities) can mirror out-of-court financings, with multiple tranches and lenders taking first-priority liens on different pools of collateral or with DIP agents syndicating participation in the DIP loan to a larger pool of lenders. All of these tools help DIP lenders distribute and minimize risk and increase the attractiveness of DIP financing to lenders. Third, given the various previously described protections afforded to DIP loans and the inherent flexibility of the bankruptcy process, DIP financing provides DIP lenders with an opportunity and leverage to seek to acquire a stake in the debtor company's assets or equity in the reorganized company. As such, while DIP financing is still largely provided by existing secured lenders, the composition of DIP lenders has begun to change. As competition for DIP lending opportunities increases, and as the pool of non-traditional DIP lenders continues to expand, directors and officers should work with their advisors to canvass a wide group of potential lenders to enable them to negotiate more favorable pricing and other terms.

Another important recent development in DIP financing is the rise of so-called equity conversion DIPs. While the Bankruptcy Code requires a DIP facility to be paid in full in cash upon the company's emergence from Chapter 11, the company and its DIP lender are free to negotiate an alternative treatment of the DIP, including the satisfaction of DIP obligations through the provision of replacement debt owed by the reorganized company or equity in the reorganized company. With increasing frequency, DIP lenders have opted to have their DIP claims satisfied through equity in the reorganized company. Indeed, some DIP lenders have recently sought, as a condition to approving the DIP facility, judicial approval of an equity conversion option in favor of the DIP lender at the early stages of a Chapter 11 case. While some courts have been reluctant to approve this sort of option at the outset of a bankruptcy case, directors, officers and companies' advisors should continue to evaluate upfront creative options for addressing DIP claims at emergence, particularly where borrowers are experiencing a cash shortage. Moreover, while an equity conversion option exercisable by the lender has drawn some judicial scrutiny, equity conversion options exercisable by the debtor company may pose fewer issues.

While DIP financing is the norm for financing most large Chapter 11 cases, there are alternative financing tools that companies can consider depending on the facts of the case. For example, section 363 asset sales (which allow a company to sell its assets free and clear of liens and claims outside of a plan) may provide companies with liquidity in lieu of, or in conjunction with, DIP financing — allowing the debtor to eliminate the need for, or reduce the amount of, DIP financing or to limit the DIP facility to a short-term liquidity bridge through the receipt of proceeds of a section 363 sale. More recently, at least one public company in Chapter 11 sought court permission to issue equity at market prices post-petition because of upward trends in their stock price during the pendency of the case. While this attempt was ultimately abandoned, it remains to be seen whether other public companies will try to capitalize on changes to their stock price in bankruptcy in an attempt to increase liquidity and reduce their reliance on DIP financing.

## Conclusion

DIP financing is a critical element of most large Chapter 11 bankruptcy cases. DIP loans provide companies with much needed liquidity to finance their restructuring efforts in Chapter 11. The cost of DIP loans is the substantial protections and significant control and influence in the Chapter 11 case that DIP lenders demand. The most successful DIPs will balance a lender's need for protection and certainty with a company's need for flexibility and liquidity. Directors and officers of distressed companies will be well served to work with their advisors closely to understand the standards by which DIP facilities are evaluated, any governance issues related to a particular DIP, the various protections that they can expect DIP lenders to request, the motivations that are likely to drive potential lenders, and the latest DIP developments and DIP alternatives.

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