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Early Stage Capital Raising Trends in Chapter 11 Reorganizations

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Key Points

- DIP loans that provide the option to convert into equity of the reorganized debtor, functioning like a rights offering, are becoming increasingly popular. But they may be rejected if they appear to effectively set terms of a Chapter 11 plan at the outset of the case without the protections of the confirmation process.
- Two cases involving proposed DIP financings with attached equity rights features and a subsequent rights offering point to the importance of providing evidence that terms are in accordance with the market and fair to those not able to participate.

Rights offerings have become a key tool for companies in Chapter 11.[1] They can address liquidity needs, help demonstrate plan feasibility and facilitate plan negotiations.

Rights offerings, however, may also serve as lightning rods, drawing objections to plan confirmation. These issues boil down to whether the consideration paid by the debtor's estate in return for the creditors' participation in the rights offering/backstop reflects the actual value to the estate of that participation or, instead, includes an impermissible payment (such as for the creditors' vote on a plan) that is not shared with similarly situated creditors who were not allowed to participate in the offering/backstop on the same terms or at all.

In this article, we look at two related trends:

- The inclusion of rights offering features in debtor-in-possession (DIP) financings.
- Focus by bankruptcy courts on the evidentiary record required to support proposed capital raising transactions.

[1] In rights offerings, existing creditors may purchase equity (and in limited situations, debt) in the reorganized company at a subscription price, often reflecting a steep discount to the "plan value" (or "fair value" in nonplan scenarios) and receive fees. Generally, a core group of creditors agrees to backstop the proposed offering for additional consideration.

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DIP Loan Equity Options

To incentivize DIP lending, the Bankruptcy Code provides superpriority liens and priority status to the loan. Courts have, especially in tight credit markets, permitted additional pro-lender DIP protections. Lately, some proposed DIP financings have provided an option to convert all or part of a DIP loan into equity in the reorganized debtor, at a premium to cash repayment.[2] Though different from traditional rights offerings, these equity-linked DIP loans have some similar features and have received similar objections:

- **Benefits.** With a DIP equity conversion, the debtor can obtain exit financing without refinancing the DIP loan at confirmation or rolling the DIP loan into a post-Chapter 11 exit facility. The DIP lender potentially may benefit from increased equity value in the post-emergence, deleveraged company. For backstop parties, extra benefits include backstop premiums, often paid in additional equity, along with fees.
- **Objections.** Parties that are not offered an opportunity to participate in a DIP loan with an equity conversion feature may raise objections similar to those levied against rights offerings. They may argue that the terms of the equity conversion feature are not properly valued (for example, as an option would) or marketed, unfairly discriminate against similarly situated creditors who were excluded from participating, or otherwise have unfair terms or are not in good faith.

Equity-linked DIP loans also raise another challenge. Because they are proposed at the beginning of the case, it may be argued that they impermissibly lock in parts of a plan by assigning a right to the still-to-be reorganized debtor's equity without the protections that stakeholders may otherwise be entitled to in connection with plan confirmation.

Two cases in the U.S. Bankruptcy Court for the Southern District of New York focus on these issues:

- *In re LATAM Airlines Group S.A.*, No. 20-11254 (JLG), 620 B.R. 722 (Bankr. S.D.N.Y. 2020).
- *In re SAS AB*, No. 22-10925 (MEW), 644 B.R. 267 (Bankr. S.D.N.Y. 2022).

[2] This feature seems to be gaining popularity. For one, in *In re Party City Holdco Inc.*, No. 23-90005 (DRJ) [ECF No. 587] (Bankr. S.D. Tex. Mar. 3, 2023), Judge David R. Jones approved a DIP agreement allowing the backstop DIP lenders to convert their DIP loans into equity of the reorganized company at par value. In two more recent cases, *In re QualTek Services Inc.*, No. 23-90584 (CML) (Bankr. S.D. Tex.) and *In re Diebold Holding Company, LLC*, 23-90602 (DRJ) (Bankr. S.D. Tex.), the debtors have proposed more aggressive DIP equity conversion features. In both cases, the DIP backstop lenders would receive a commitment to a certain percentage of equity in the reorganized company as consideration for backstopping the DIP loan. While both DIPs have been approved on an interim basis, at the time of this writing, neither have received final approval.

The court in *LATAM* rejected the equity conversion term in a proposed DIP agreement, while the *SAS* court allowed one while expressing serious reservations. When *LATAM*'s reorganization plan was later confirmed, however, a related rights offering on somewhat different terms was approved.[3]

LATAM. The debtors sought approval of a $2.5 billion DIP loan that provided certain of the proposed lenders, who were existing shareholders, the option of repayment in equity in the reorganized company at a 20% discount to the equity's "plan value." Multiple objectors contended that the terms were not "at market" and thus not for fair value provided by the lenders and, in addition, constituted a *sub rosa* plan that also would, as to the equity to be allocated to shareholders, violate the Bankruptcy Code's absolute priority rule. Judge James L. Garrity, Jr. found that the entire fairness standard (applicable because the loan involved "insiders") was satisfied but denied the equity conversion aspect of the DIP agreement because it constituted a *sub rosa* plan that would improperly allocate a right to the reorganized debtor's equity without a valuation or the other protections available in the plan confirmation process and that risked violating the Bankruptcy Code's absolute priority rule before a vote on a plan.

SAS. The debtors proposed a $700 million DIP facility with two equity features: an equity conversion option and tagalong rights. Judge Michael E. Wiles questioned the equity conversion rights in a DIP loan and the ability to value the equity options compared to the DIP loan benefits provided to the debtors. Nevertheless, Judge Wiles approved the DIP loan because: (1) after renegotiating the equity-linked features, no parties continued to object to the arrangement, and (2) the options were revocable by the debtor, albeit subject to fees on revocation.

Focus on Fair Market Value Evidence

The courts in *LATAM* and *SAS* hesitated to approve equity conversions at the DIP loan stage at least in part because the valuations underlying the proposed equity conversions were not tested by the market. The courts expressed concern that the price paid by the estate for the DIP loan/conversion feature (including the backstop) could be higher than the value of the DIP loan/conversion feature to the estate.

This raises the question: How should courts assess the "market" and fairness of such terms?

Courts have long recognized that a fair market test is the best way to value an asset. The U.S. Supreme Court has reasoned that a market test would make it easier for bankruptcy judges to decide a transaction's

[3] *In re LATAM Airlines Grp, S.A.*, No. 20-11254 (JLG), 2022 Bankr. LEXIS 1725 (Bankr. S.D.N.Y. June 18, 2022), *aff'd*, 643 B.R. 756 (S.D.N.Y. 2022).

fairness.[4] In practice, however, potential "market" alternatives are often skewed, or do not arise at all, because of the high entry costs that true third parties face in competing with a DIP loan offered by existing lenders whose right to adequate protection of their collateral supports their objection to being primed by a third party. Thus, courts may need to look at valuation evidence in the absence of competing bids in order to determine the fairness of the proposed transaction.

At the plan confirmation stage in *LATAM*, Judge Garrity reviewed and approved a proposed modified rights offering, but only after taking considerable valuation evidence.[5] Of note was the parties' acknowledgment that their evidence and analysis of assertedly comparable rights offerings were in material respects novel. Notwithstanding several courts' prior approval of rights offerings/backstops in conjunction with plan confirmations, *LATAM* is the first case to our knowledge where a bankruptcy judge looked closely at the terms of assertedly comparable past rights offerings/backstops and proposed comparative valuation methodologies to determine the fair value of proposed backstop fees and discounts to "plan" equity value in such a rights offering.[6]

Whether the offering/backstop is a fair *quid pro quo* for consideration provided by the participants or, instead, an overpayment to them ultimately hinges on a valuation determination. Thus, one can expect that such valuation analyses will become more common and more refined in the future.

[4] *Bank of America Nat. Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

[5] As noted in the district court's opinion affirming Judge Garrity's confirmation opinion, 643 B.R. at 764 65, Judge Garrity's confirmation opinion largely incorporated his valuation analysis set forth in his opinion on the proposed backstop agreement, appearing at 2022 Bankr. LEXIS 649 at *78 120 (Bankr. S.D.N.Y Mar. 15, 2022).

[6] In I*n re Pac. Drilling S.A.*, No. 17-13193 (MEW), 2018 Bankr. LEXIS 3024 (Bankr. S.D.N.Y. Oct. 1, 2018), Judge Wiles noted the paucity of evidence submitted to support a backstop fee but approved a modified fee in light of its being unopposed.

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