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Chapter 11 Financing: Roll-Ups, Roll-Overs and Creeping Roll- Overs

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CHAPTER 11 FINANCING: ROLL-UPS, ROLL-OVERS AND CREEPING ROLL-OVERS

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Topics to Cover

- Lending Strategies & 11 U.S.C. § 364
- Impact of Prepetition Intercreditor Agreement
- Priming DIP Loans
- DIP Motion: Terms and Process
- Standalone DIP Facility
- “Roll-Up” / “Roll-Over” DIP Facility
- “Creeping” “Roll-Up” / “Roll-Over” DIP Facility
- Desirable Provisions in DIP Financing
- Cash Collateral Orders v. DIP Orders
- DIP Financing: the “Exit”
- ABI Commission Report: Impact on DIP Financing
- Questions & Answers

Setting the Stage: Two Lending Strategies

- Free-standing / Offensive Debtor-in-Possession (DIP) Financing
 - No corresponding adequate protection package for lender's prepetition exposure
 - Usually provided by nonbank entities, specialty finance entities or strategic buyers
 - Most important issues are those that would arise in non-bankruptcy setting
 - Absent consent, requires a priming fight
- Protective / Defensive DIP Financing
 - Lender is a prepetition lender
 - Debtor incented to trade favorable adequate protection for better DIP terms
 - Lender incented to extend further credit to preserve value of prepetition collateral
 - May avoid a priming fight

Setting the Stage: 11 U.S.C. § 364

Unsecured Credit - §§ 364(a), (b) and 503(c)(1)

Superpriority Administrative Claim - § 364(c)(1)

Lien on Unencumbered Property - § 364(c)(2)

Junior Lien on Encumbered Property - § 364(c)(3)

Priming Lien on Encumbered Property - § 364(d)

Setting the Stage: 11 U.S.C. § 364

Unsecured Credit

11 USC § 364(a): “If the trustee [or DIP] is authorized to operate the business of the debtor . . . the trustee may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.”

Setting the Stage: 11 U.S.C. § 364

Superpriority Administrative Claim

11 USC § 364(c)(1): “If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.”

- *Unsecured credit CANNOT be available.*

Setting the Stage: 11 U.S.C. § 364

Lien on Unencumbered Property

11 USC § 364(c)(2): “If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.”

- *Unsecured credit CANNOT be available.*

Setting the Stage: 11 U.S.C. § 364

Junior Lien on Encumbered Property

11 USC § 364(c)(3): “If the trustee is unable to obtain unsecured credit allowable under section 503(b)(1) of this title as an administrative expense, the court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt –

(1) with priority over any or all administrative expenses of the kind specified in section 503(b) or 507(b) of this title;

(2) secured by a lien on property of the estate that is not otherwise subject to a lien; or

(3) secured by a junior lien on property of the estate that is subject to a lien.”

- *Unsecured credit CANNOT be available.*

Setting the Stage: 11 U.S.C. § 364

Priming Lien on Encumbered Property

“(1)The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if—

(A) the trustee is unable to obtain such credit otherwise; and

(B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.

(2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.”

11 USC § 364(d)

Setting the Stage: 11 U.S.C. § 364

Priming Lien on Encumbered Property, Cont'd

Requirements for Priming Lien:

- (1) No other credit available.
11 USC § 364(d)(1)(A)
- (2) Adequate protection to the primed lender.
11 USC § 364(d)(1)(B)

The trustee or DIP bears the burden of proof on adequate protection.

11 USC § 364(d)(2)

Impact of Prepetition Intercreditor Agreement

- Provision of DIP financing
 - First lien lender or (with consent) third party, subject to certain conditions
 - Second lien lender waives its right to contest, subject to certain conditions
- Cap on aggregate amount of first lien debt and DIP financing
 - Market expectations of a “cushion” and when it’s available
 - Draft with an eye towards a “roll-up” of prepetition debt
- Second lien lender’s contractual subordination of liens
 - Lien of the DIP lender (up to the cap)
 - Any adequate protection liens granted to the first lien lender
 - Any carve-out agreed to by the first lien lender

Impact of Prepetition Intercreditor Agreement

- Potential rights of a second lien lender
 - Object on any ground that an unsecured creditor could assert
 - Perhaps limited by a “commercial reasonableness” standard
 - Never on grounds of adequate protection
 - Receive adequate protection (if first lien lender receives the same)
 - Object if DIP:
 - Does not prime or is *pari passu* with the first lien
 - Purports to dictate terms of a plan
 - Purports to require liquidation of collateral
 - Isn’t subject to the intercreditor agreement (rare, but impact is profound)
 - May have opportunity to provide a non-priming DIP

Priming DIP Loans

- Postpetition credit granted superpriority status through § 364(d); requires provision of “adequate protection” to senior lienholder
- Meaning of adequate protection
 - Protection from certain effects of the bankruptcy process (e.g., diminution)
 - New financing as improvement of value of collateral
 - Example: *In re Hubbard Power & Light*, 202 B.R. 680 (Bankr. E.D.N.Y. 1996)
 - Three general approaches guided by § 361
 - (1) Single or periodic cash payment to creditor
 - (2) Replacement lien as compensation for diminution of value of interest
 - (3) Catch-all “other relief . . . of the indubitable equivalent”
 - Not an administrative priority claim; perhaps a meaningful equity cushion

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Priming DIP Loans

- Procedural Steps to provide for a priming DIP under § 364(d):
 - § 364(d) requires “notice and a hearing”
 - notice and an **opportunity** for a hearing; actual hearing not always required
 - Trustee or DIP have burden to show §§ 364(a) and (b) unavailable, and that adequate protection is provided
 - Notice, contents of motion, local rules and hearing timing (see next slides)
- A Priming DIP loan
 - Often threatened, but seldom attempted
 - Equity cushion as adequate protection: how much is enough?
 - Alternative arguments: *Binder & Binder – The National Social Security Disability Advocates (NY), LLC, et al.*, No. 14-23728 (Bankr. S.D.N.Y. 2015)

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DIP Motion: Description of Terms

- FRBP 4001(C) sets forth items that must be a part of the motion:
 - Attach credit agreement and proposed order (FRBP 4001(c)(1)(A))
 - If motion is longer than 5 pages (and it will be), it must start with a summary of material terms (FRBP 4001(C)(1)(B))
 - Motion must contain specific provisions (see next slide)
 - Motion must be served on any committee (or, alternatively, the top 20 list)
 - Final hearing must be set on no less than 14 days' notice, **but** court may authorize interim credit “only to the extent necessary to avoid immediate and irreparable harm”

- Check local rules for additional requirements!

DIP Motion: Description of Terms

- The Motion **must** describe the nature and extent of **each** of the following:
 - A grant of priority or a lien on property of the estate under §§ 364(c) or (d)
 - Adequate protection or priority for prepetition claim (liens; cash payments)
 - A determination of the validity, enforceability, priority, or amount of a prepetition claim, or of any lien securing such claim
 - A waiver or modification relating to the automatic stay
 - A waiver or modification of any entity's authority or right to file a plan; seek extension of exclusivity period; request use of cash collateral § 363; or request authority to obtain credit under § 364
 - The establishment of deadlines for filing a plan; filing a disclosure statement; a hearing on confirmation, or entry of a confirmation order

DIP Motion: Terms

- The Motion **must** describe the nature and extent of **each** of the following (cont.):
 - A waiver or modification of the applicability of non-bankruptcy law relating to the perfection of a lien on property of the estate, or on the foreclosure or other enforcement of the lien
 - A release, waiver, or limitation on any claim or other cause of action belonging to the estate or the trustee, including any modification of the statute of limitations or other deadline to commence an action
 - The indemnification of any entity
 - A release, waiver, or limitation of any right under § 506(c)
 - The granting of a lien on any claim or cause of action arising under §§ 544, 545, 547, 548, 549, 553(b), 723(a) or 724(a)

DIP Motion: Loan Approval Process

- Debtor typically needs to draw on the facility at the outset and it is desirable to DIP lender to obtain early approval
 - Step 1: Interim DIP hearing is held within a couple of days after the petition is filed
 - At the interim hearing, the debtor seeks approval to use only that portion of the DIP commitments it will need until a final DIP hearing can be held
 - Common objections (usually raised by the United States Trustee) relate to adequate protection package, the fees to DIP lender, and whether the terms are best available
 - There may be one or more interim DIP hearings
 - Step 2: The final DIP hearing will be held within 30 to 45 days after the official committee of unsecured creditors is appointed
 - Often, the creditors' committee will object to the terms of the deal and certain terms may be renegotiated before the final hearing

Standalone DIP Facility

- Extension of new post-petition credit by either:
 - (1) a new lender; or
 - (2) a pre-petition lender without reference to the pre-petition debt
- At its core, a standalone DIP facility is no different than a traditional (non-bankruptcy) credit facility
- Requires heightened due diligence, and *Banco Panamericano, Inc. v. City of Peoria*, 880 F.3d 329 (7th Cir. 2018), serves as a cautionary tale

“Roll-Up” / “Roll-Over” DIP Facility

- DIP loan proceeds are applied to satisfy prepetition debt and thus convert it to postpetition debt
- Consummate defensive strategy: prepetition lender’s old loan now has the DIP loan’s full collateral package ***and*** its super-priority administrative status
- Among other protections, the pre-petition debt cannot be “crammed down” and must be paid in full in cash at exit of the bankruptcy; allows lender to avoid “take-back” paper

“Roll-Up” / “Roll-Over” DIP Facility

- What protections should be included in a roll-up facility
 - Courts will look generally at added value to the estate
 - It is generally not enough to only provide for the prepetition debt; there must be some newly added value to the estate
 - Undersecured prepetition creditors – is the lender really an undersecured prepetition creditor seeking only to improve its position without providing overall benefit to estate?
 - Oversecured prepetition creditors – are they in a better position?

“Creeping” “Roll-Up” / “Roll-Over” DIP Facility

- DIP financing that converts prepetition debt into postpetition debt in a ***gradual*** manner
 - Hybrid of a cash collateral arrangement and DIP financing
 - Most frequently found in the ABL and revolving credit space
- Basic mechanism
 - Debtor must apply the proceeds of prepetition collateral received postpetition (its cash) to pay down the prepetition debt
 - As the debt is paid down by such proceeds, the lender advances under the DIP facility an amount of new cash
 - Postpetition DIP financing gradually replaces the prepetition debt

“Creeping” “Roll-Up” / “Roll-Over” DIP Facility

- Argument against facility structure
 - Impermissible attempt to cross-collateralize a lender’s loan (or is it?)
 - §552(a) creates the bright line between prepetition collateral and postpetition collateral for a secured lender

- Argument in favor of facility structure
 - Proceeds are only used to fund postpetition working capital requirements
 - Compare to “roll-up”; no immediate pay down of prepetition debt
 - Postpetition cash (which might otherwise be used to fund working capital needs) is used to pay down the prepetition debt

“Creeping” “Roll-Up” / “Roll-Over” DIP Facility

- Forms that the facility may take
 - Even exchange of prepetition debt for postpetition loan (no “new” money)

 - Extension of “new money” to help balance postpetition cash flow
 - “Over-advance” under an ABL line with new borrowing limits
 - Term loan or separate tranche of debt with different terms

- As with “roll-up” DIP facilities, commitment from DIP lender to provide new money is a critical component for approval

“Creeping” “Roll-Up” / “Roll-Over” DIP Facility

- **Benefits to Debtor**
 - Access to sufficient working capital during the chapter 11 process
 - Continuity provided by a relationship with the same prepetition lender

- **Benefits to DIP Lender**
 - Repayment of the prepetition debt from orderly liquidation of its prepetition collateral (inventory and accounts)
 - Debtor may purchase new collateral to secure its postpetition loan
 - Postpetition secured claim, and postpetition administrative priority claim
 - Court-approved protections baked into the DIP facility and court order

“Creeping” “Roll-Up” / “Roll-Over” DIP Facility

- **Benefits to Other Creditors**
 - Limits roll up to more closely mirror actual needs of debtor

- **Risks to Debtor**
 - Loss of control over a plan process (if no § 363 sale or exit financing)
 - Mitigate through good prepetition planning

- **Risks to DIP Lender**
 - Lack of sufficient funding to meet working capital needs (another DIP!)
 - Mitigate through good budgeting using accurate historical financials

Desirable Provisions in DIP Financing

- Basic concepts from a non-bankruptcy credit facility
 - Interest rate pricing
 - Higher than non-bankruptcy financing, because of increased risk profile
 - Historically about 200 to 400 bps above LIBOR; 2009 peak 600 to 1200 bps
 - Fees
 - Significant upfront fees (2 to 4 percent)
 - May include exit fees, syndication fees, arranger fees, unused fees, etc.
 - Maturities
 - Historically about two years; 2009 peak closer to 9 months
 - Other concepts: collateral, insurance, reporting, governance

Source: Practical Law Finance: Key Developments and Trends in DIP Financing, Thomson Reuters (February 19, 2015)

Desirable Provisions in DIP Financing

- | | | |
|--|---|---|
| <ul style="list-style-type: none"> ▪ Taco Bueno Restaurants <ul style="list-style-type: none"> ▪ \$10MM term ▪ 7% fixed ▪ No fees ▪ Priming; no roll up ▪ 4 month maturity | <ul style="list-style-type: none"> ▪ Gymboree Group, Inc. <ul style="list-style-type: none"> ▪ \$119MM term ▪ L+825 & L+1125 ▪ 2% commitment; 4% prepay ▪ Priming; \$30mm roll up ▪ 7 month maturity | <ul style="list-style-type: none"> ▪ Mattress Firm, Inc. <ul style="list-style-type: none"> ▪ \$250MM (\$150MM ABL) ▪ L+250 ABL; 10% term ▪ No fees ▪ Priming; full roll up ▪ 3 month maturity |
| <ul style="list-style-type: none"> ▪ Geokinetics, Inc. <ul style="list-style-type: none"> ▪ \$15MM delayed draw ▪ L+500 cash; L+1100 PIK ▪ Small agency fee (\$22M) ▪ Junior priority ▪ 50 days | <ul style="list-style-type: none"> ▪ EdgeMarc Energy <ul style="list-style-type: none"> ▪ \$107MM term ▪ ABR+~575 (~11% floor) ▪ Upfront, unused, exit fees ▪ Priming; roll up ▪ 6 months | <ul style="list-style-type: none"> ▪ SouthCross Energy <ul style="list-style-type: none"> ▪ \$225MM term ▪ L+1000 new; L+500 roll up ▪ Many small (1%) fees ▪ Priming; \$127mm roll up ▪ 6 months (can extend) |

Source: Reorg Research First Day Database (www.reorg.com) (Accessed May 27, 2019)

Desirable Provisions in DIP Financing

- Special chapter 11 provisions: certain issues that almost never crop up in non-bankruptcy situations arise in virtually every DIP credit facility. For example:
 - Budgets
 - Ties cash receipts and expense targets to permitted variances
 - Budget variances generally range from 10-20% for the reporting period
 - Line item basis, overall budget basis or combination of the two
 - Carve-outs
 - Ongoing expense for professional fees for all parties
 - Subject to a cap, which may be tied to occurrence of event of default

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Desirable Provisions in DIP Financing

- Special chapter 11 provisions (con't):
 - Milestones
 - Affirmative covenant tied to expected "exit" strategy
 - Bankruptcy-related events of default
 - Challenge to DIP lender's liens or claims
 - Relief from stay in favor of third party on assets
 - Change of venue, conversion to a chapter 7, appointment of trustee
 - Bankruptcy-related remedies
 - Immediate right to stop lending
 - Realize on its collateral without having to appear before the court

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Desirable Provisions in DIP Financing

- Special chapter 11 provisions (con't):
 - Waivers related to prepetition liens and claims
 - Generally, debtor may concede these issues, but not third parties
 - Challenge period established for third parties
 - Prohibition of further DIP financing
 - Either limit future DIP lender's rights, or require immediate repayment
 - Waiver of surcharging the DIP lender's collateral
 - § 506(c) allows surcharge for preservation or disposition of collateral
 - Impact most significantly felt on a subsequent chapter 7 trustee

Desirable Provisions in DIP Financing

Common Provisions

- Budgets
- Carve-outs
- Milestones
- Bankruptcy-related events of default
- Post-default relief from stay
- Automatic perfection of liens
- Borrowing bases

Might be an Overreach

- Lender's debt is valid and liens perfected (w/o challenge period)
- More than milestones (affirmative control/direction)
- Liens on avoidance actions

Cash Collateral Orders v. DIP Orders

- Cash Collateral Orders (§ 363)
 - Involves “old money” already in possession of debtor
 - Lien structure is intended to maintain prepetition priority
 - Allows for work with existing vendors and lenders
 - Often included as a “First Day” Order
- DIP Financing Orders (§ 364)
 - Involves “new money” made available through postpetition facility
 - Lien structure often involves “priming” of prepetition priority
 - Creates cash infusion to address significant working capital needs
 - Host of new terms and conditions; a “First Day” motion for interim relief

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DIP Financing: the “Exit”

- DIP facility is not paid until all prepetition debt has been replaced
- Three approaches to repayment (absent default and collection)
 - (1) § 363 sale of assets
 - Most common approach
 - DIP lender has a hand in the negotiation of APA; milestones tie to sale
 - (2) Exit financing
 - Applicable when case is a true restructuring
 - DIP may be post-confirmation lender
 - (3) Plan process
 - Require cash payment in full upon confirmation, so make decision early
 - May provide for different treatment with consent of DIP lender

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ABI Commission Report: Impact on DIP Financing

- Overall theme of report is that pervasive use of aggressive DIP lender protections has tipped the bankruptcy process too much in favor of DIP lenders

- ABI Commission identified five (5) issues
 - Timing
 - Control of case and/or plan process
 - Roll-up of debt
 - Liens on avoidance actions or proceeds
 - Waiver of debtor's rights under the Bankruptcy Code

Questions

Questions and Answers

Presenters



Peter J. Barrett represents creditors, trustees, lessors, equity holders and corporate debtors in insolvency matters, including chapter 11 reorganizations, business liquidations and loan workouts. Based in the Richmond, Virginia office of Kutak Rock LLP, Peter also serves as a member of the panel of chapter 7 bankruptcy trustees for the Eastern District of Virginia, Richmond Division.

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The Honorable Kevin R. Huennekens was appointed as a United States Bankruptcy Judge for the Eastern District of Virginia, Richmond Division, on September 11, 2006. Prior to his appointment, Judge Huennekens was a partner with the firm of Kutak Rock LLP and served as a Chapter 7 panel trustee.



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