DIP Best Practices

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Best Practices in DIP Financing : The Entire Fairness Standard as It Applies to Equity Sponsors in Portfolio Company Bankruptcies

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Standards of Review & Debtor Transactions

- The Bankruptcy Code does not define a standard of review for the court to apply in considering whether to approve a transaction outside of the ordinary course of business.
- In the absence of a statutory standard, bankruptcy courts adopted the well-developed standards of state law for reviewing corporate decisions.

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Possible Standards of Review

- Generally, the **Business Judgment Rule** for third party transactions.
- If an "insider" of the debtor benefits from the transaction (especially a controlling insider):
  - **Heightened Scrutiny**; or
  - **Entire Fairness**.

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Standard of Review: Business Judgment Standard

- Highly deferential review.
- The court will not substitute its judgment for that of the debtor, either prospectively by injunction or retrospectively by imposing liability.
- Satisfied if a transaction has some "rational business purpose" and does not result from a grossly negligent decision-making process.

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Standard of Review: Insider Transactions

- If a fiduciary (*e.g.*, board member, officer, controlling shareholder) stands on both sides of a deal.
- Someone is a controlling shareholder if: (i) has the power, either directly or indirectly, to control the actions of a company; and (ii) actually exercises that power.
- Examples:
  - A private sale to an insider;
  - An insider offers postpetition financing;
  - An insider offers to act as a stalking horse bidder;
  - In some circumstances, a plan that transfers control to an insider; or
  - Other transaction with a controlling shareholder.

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Standard of Review: Entire Fairness

- Most stringent level of review.
- In-depth judicial review of the terms and process of the transaction. The initial evidentiary burden is on the conflicted fiduciary to show:
  - Fair price; <u>and</u>
  - Fair dealing.
- <u>When applied</u>. If the party opposing a transaction can show:

(1) the directors did not in fact make a decision;

(2) the directors' decision was uninformed;

(3) a majority of the directors were not disinterested or independent;

(4) the directors were grossly negligent; or

(5) the transaction is with a controlling shareholder.

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Standard of Review: Entire Fairness
In re Los Angeles Dodgers LLC

- The Dodgers sought the approval of a DIP loan from Highbridge.
- The loan from Highbridge would have benefited Frank McCourt, the Dodgers' controlling stockholder, by relieving him of over $5 million in personal debt.
- The Highbridge loan therefore provided a unique benefit to Mr. McCourt.
- A materially better DIP facility was available from Major League Baseball.

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Standard of Review: Entire Fairness
In re Los Angeles Dodgers LLC

COMPARISON OF MATERIAL DIP TERMS

	Highbridge DIP Facility	MLB DIP Facility
Fees:	0.50% Delayed Draw Fee $4.5 MM Deferred Comm Fee $5.25 MM Closing Comm Fee $50,000 Annual Agent Fee	None
Interest Rate:	LIBOR + 6% (3% Floor) Base Rate + 6.0%	LIBOR + 5.5% (1.5% Floor) Base Rate + 4.5%
Security:	All Estate Assets	Unsecured
Priority:	Super-Priority Administrative	Administrative
Events of Default:	Case Dismissal Trustee or Examiner Appointed Termination of certain agreements with MLB	Less onerous events of default
Maturity Date:	June 27, 2012	November 30, 2012
Benefits for Frank McCourt	McCourt would be relieved of $5.25M of personal debt	McCourt more likely to lose control of the team

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Standard of Review: Entire Fairness
In re Los Angeles Dodgers LLC

- The court could not find that the Highbridge loan was fair because financing on better terms was offered by MLB.
- The court also questioned the process because the debtors did not engage MLB regarding its competing financing offer.
- Therefore, the court did not approve the transaction, holding that it was not entirely fair.
- The court directed the debtors to negotiate with MLB to reach agreement on a loan from MLB.

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Standard of Review: Entire Fairness
UCI International, LLC

- UCI sought the approval of a DIP loan from Rank Finance and Credit Suisse.
- Graeme Hart controlled each of UCI, Rank Finance and AH Group.
- UCI and AH Group were two auto parts companies with highly integrated operations.
- AH Group unilaterally terminated many of the service agreements it held with UCI shortly before bankruptcy.
- UCI appointed an independent director several months before bankruptcy, but the independent director was not empowered by the UCI board (comprised of Mr. Hart's appointees) to negotiate with AH Group or third parties for financing prior to the bankruptcy.

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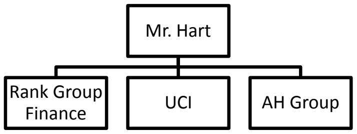
Standard of Review: Entire Fairness
UCI International, LLC



* The operations of UCI and non-debtor, AH Group were highly integrated

** Rank Group Finance has a close relationship with Credit Suisse, investing in numerous joint projects

Timeline: Hart's attempt to separate AH Group from UCI to avoid UCI liabilities

July 2015	Credit Suisse issued an ABL to UCI
Dec. 2015	Credit Suisse transferred a large portion of the ABL to Rank Group Finance
Feb. 2016	Independent director appointed to the UCI board (but not given authority over many decisions until the bankruptcy filing)
May 2016	AH Group begins to cancel joint service agreement with UCI
	Other UCI counterparties begin issuing notices of termination

Competing DIP Facilities

Rank and Credit Suisse:	100% roll-up of prepetition ABL upon close.
Ad hoc noteholder group:	Wedge DIP priming Rank's ABL position, but not Credit Suisse's ABL position.
	Credit Suisse would not support this DIP, citing its relationship with Rank Group Finance.

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Standard of Review: Entire Fairness
UCI International, LLC

- ☐ UCI's independent director approved the DIP loan proposed by the Hart-controlled Rank entity and Credit Suisse.
- ☐ The court found that despite such approval, the process was not entirely fair.
- ☐ Key finding: Before the independent director was authorized to review UCI's decisions, Mr. Hart's actions effectively limited the independent director's discretion to refuse the Rank/Credit Suisse DIP.
- ☐ The court therefore did not approve the DIP loan, finding that the transaction was not entirely fair given the history.

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Standard of Review: Entire Fairness
Innkeepers

- Innkeepers sought to assume a plan support agreement with a secured creditor, Lehman.
- The PSA would transfer 100% of the reorganized equity to Lehman. All other secured creditors would receive new loans.
- Under a separate agreement, Lehman would then transfer 50% of the new equity to Innkeepers' pre-bankruptcy parent company.
- The PSA contained a "no talk" provision. Before filing the PSA with the bankruptcy court, Innkeepers' CRO did not disclose the existence of the PSA or the Lehman-parent agreement to creditors.
- The court found the lack of disclosure "troubling."

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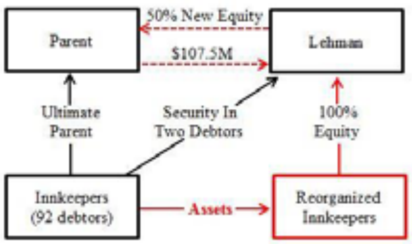
Standard of Review: Entire Fairness
Innkeepers



*Lehman held $238 million in mortgages against two debtors
**The debtors had roughly $1.5 billion in total secured debt

Relevant Facts: Parent's secret deal to keep control

Parent begins exploring strategies to maintain its equity through a bankruptcy process

PSA between Innkeepers and Lehman

- Innkeepers will transfer its assets to New Innkeepers
- In satisfaction of its mortgages, Lehman will receive 100% of New Innkeepers equity
- Other secured lenders will receive new loans

Side Deal: Lehman agrees sell Parent 50% of New Innkeepers equity

Innkeepers did not disclose the existence of the side deal or the PSA to creditors

Innkeepers moves under section 365 to approve the PSA

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Standard of Review: Entire Fairness *Innkeepers*

- The PSA's terms (*i.e.*, its price) did not satisfy the entire fairness standard because it provided nearly zero value for parties other than Lehman and the parent.
- The court also found that the process was not fair because:
  1. The debtors never "shopped the term sheet" to any other party;
  2. The debtors did not determine a value of the new Innkeepers' equity; and
  3. The PSA had a strict no talk provision.
- The court was also troubled by the lack of disclosure of the PSA in prepetition discussions with other parties in interest.

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Standard of Review: Heightened Scrutiny

- Between business judgment and entire fairness.
- This is a "hybrid" standard that does not appear to have a counterpart in the nonbankruptcy corporate context.
- The court takes a close look at an insider's involvement, but the burden of proof likely remains on the party opposing the transaction.
- Applies if the party opposing the transaction shows that an insider was involved, but cannot show that an insider controlled the transaction.

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Standard of Review: Heightened Scrutiny *TerreStar Networks Inc.*

- ☐ TerreStar sought authority to assume an RSA and enter into DIP financing with EchoStar.
- ☐ EchoStar held roughly 15% of TerreStar's equity. That interest included a "black marble" provision that allowed EchoStar to veto certain major corporate actions, giving EchoStar "negative control" as a result of the provision.
- ☐ Under the RSA,[1] EchoStar would:
  1. Receive a large portion of reorganized stock;
  2. Retain much of its prepetition debt; and
  3. Backstop the majority of a rights offering.
- ☐ TerreStar entered bankruptcy without exploring other reorganization or sale options.

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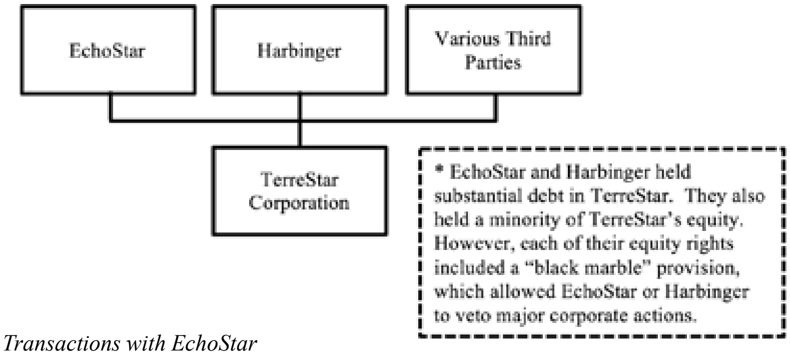
[1] The debtors ultimately voluntarily withdrew the RSA motion.

Standard of Review: Heightened Scrutiny *TerreStar Networks Inc.*



- ❑ *Proposed Transactions with EchoStar*
  - ❑ RSA: EchoStar would receive
    - ❑ 15% of new common equity
    - ❑ Option for new preferred stock
    - ❑ Reinstatement of certain debt
  - ❑ EchoStar DIP
  - ❑ EchoStar Backstop Agreement

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Standard of Review: Heightened Scrutiny *TerreStar Networks Inc.*

- The evidence was insufficient to show that EchoStar had used the "black marble" provision to control TerreStar's actions. Thus, the court did not apply the entire fairness standard.
- Because TerreStar was receiving a significant benefit, the court decided that the business judgment standard was not sufficient. Instead, it applied "some heightened scrutiny[,]" giving "special attention" to the DIP financing terms.
- The court ultimately permitted TerreStar to enter into the DIP financing transaction.
- Question to consider: Would the result have changed if EchoStar had exercised its rights under the black marble provision?

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Avoiding Entire Fairness Review

- Even if an insider is involved in a transaction, a court may apply the business judgment standard if a debtor takes steps to prevent an insider from controlling the transaction.
- Methods for avoiding heightened scrutiny include:
  - Appointing an independent director and giving that director authority to make decisions and approve actions;
  - Using separate advisors for the independent director and the insider;
  - Executing a public negotiations process; and
  - Making a record of arm's length negotiations with the insider.

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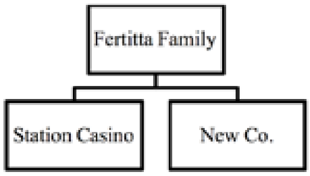
Avoiding Entire Fairness Review: What Works
In re Station Casino Inc.

- The court approved sale procedures that contemplated two transactions that would likely result in the debtors' casino-hotels being retained by the debtors' controlling shareholder, the Fertitta family. To sanitize the deal, the debtors used an **independent director and made a record of the negotiation process** with the Fertitta family.



Section 363 Sale (transfer half the assets)
- Stalking Horse: New Co.
- Overseen by an independent director

Plan
- Remaining assets to New Co.

- The court approved the sale procedures noting two significant facts:
  - The debtors' independent director would control the sale process; and
  - The Fertittas' stalking horse bid resulted from arm's-length negotiation conducted by the independent director.

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Avoiding Entire Fairness Review: What Works
In re Residential Capital, LLC

- Residential Capital sought authority to assume a PSA with several parties, including its indirect parent, Ally Financial.

- The court applied the business judgment standard and permitted Residential Capital to enter into the PSA.

- The court applied the business judgment standard because:

  1. The PSA was the result of a court-supervised mediation process; and

  2. During the mediation, Residential Capital was represented by a CRO that was not beholden to Ally.

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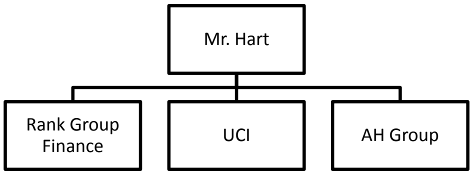
Avoiding Entire Fairness Review: What Doesn't Work
UCI International, LLC



Timeline

- Independent director appointed, but without full authority
- AH Group begins canceling joint services agreements with UCI. Independent director not empowered to negotiate with AH Group.
- UCI files for bankruptcy and independent director is empowered
- Rank Group Finance offers DIP loan and, as part of DIP loan, forbearance on joint service agreement terminations.
- The independent director chooses Rank DIP loan in part because of joint service agreement concessions from Rank affiliates.
- Court denies Rank DIP loan

"*You can't screw up the debtor completely, and then appoint an independent director and make everything all right, by letting the independent director have free reign in doing what it can to clean up the mess.*"

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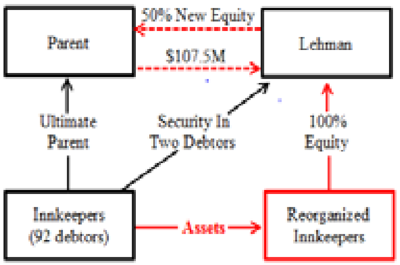
Avoiding Entire Fairness Review: What Doesn't Work
Innkeepers USA Trust



- Parent caused Innkeepers to execute a PSA with Lehman, providing Lehman 100% of Innkeepers' reorganized equity.
- Concurrently, Parent executed an agreement with Lehman, providing that Lehman would transfer 50% of the new equity back to Parent.
- Parent did not permit Innkeepers' CRO to perform due diligence, market Innkeepers' assets to other parties, or reveal the existence of the PSA or Parent agreement.
- The court found that Parent's indirect use of Lehman did not make the process fair.

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Note on Alternative Entities
Houston Regional Sports Network, L.P.

- Houston Regional Sports Network (the "Network"), a Delaware limited partnership, was a failing joint venture between the Houston Astros, the Houston Rockets, and Comcast.
- Affiliates of Comcast and the Network filed an involuntary petition against the Network.
- The Astros opposed the filing, however, arguing that the Network's partnership agreement gave it the authority to block any reorganization efforts. Pursuant to the partnership agreement:
  - The Astros controlled one member sitting on the Network's board;
  - Board members had absolute right to veto major decisions; and
  - Under the partnership agreement, Board members were absolved from fiduciary duties to the Network or its partners and could freely act in their or their affiliates' interests.

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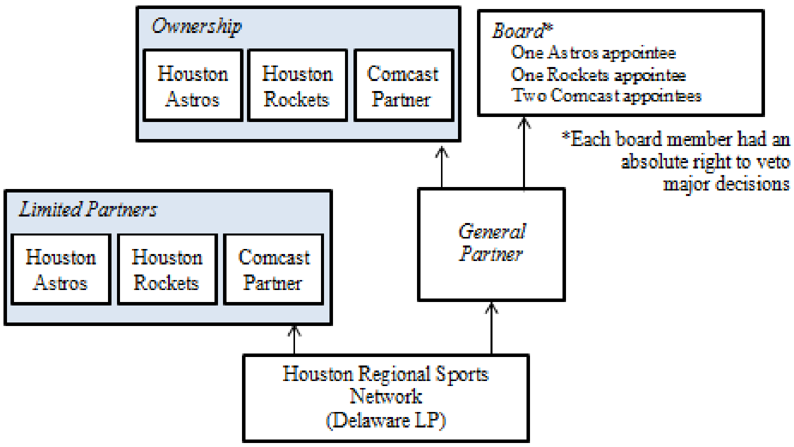
Note on Alternative Entities
Houston Regional Sports Network, L.P.



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Note on Alternative Entities
Houston Regional Sports Network, L.P.

- The Astros argued that it could block reorganization efforts because the partnership agreement absolved board members from fiduciary duties and permitted actions in own best interest.
- The court held that any party that manages a debtor owes a fiduciary duty to the bankruptcy estate.
- Thus, the Astros and its board member could not arbitrarily block any reorganization option.
- *Court's reasoning suggests that waiver of duty that may be given effect in a nonbankruptcy setting may not insulate from entire fairness review in bankruptcy.*

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Best Practices

- Methods of insulating transactions from heightened scrutiny:
  - Independent decision-maker (empowered and with meaningful involvement in the process);
  - Separate counsel for board and insider;
  - Documented arm's length negotiations with the insider; and
  - Shopping the transaction to third parties.

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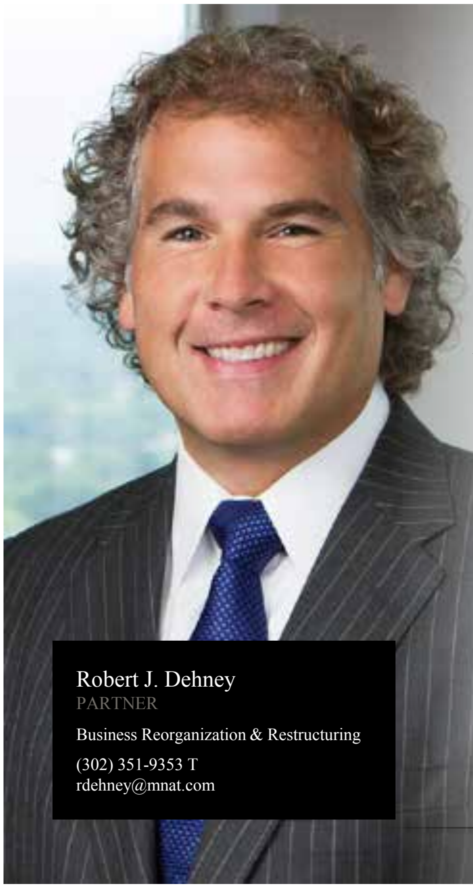

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Speaker

For more than 20 years, Rob Dehney's practice has focused on corporate restructuring and counseling including representation of boards of directors and committees. A former law clerk to the Honorable Prudence Beatty of the U.S. Bankruptcy Court for the Southern District of New York and formerly with Willkie Farr & Gallagher in New York City, Rob has spearheaded the growth and success of the Morris Nichols Business Reorganization & Restructuring Group—top-tier rated by *Chambers USA*, regarded by the *Daily Bankruptcy Review* as one of the most prolific restructuring and reorganizing practices in the United States, and 2012, 2010 and 2009 winner of Turnaround Atlas Awards and 2009 recipient of *M&A Advisor* U.S. Middle-Market Financing Award.

Rob's substantial experience extends to representations of debtors and creditors in all facets of pre- and post-Chapter 11 filings that include out-of-court reorganization and restructuring, acquisitions and complex lending arrangements. He also provides corporate governance, fiduciary duty and strategic advice to boards of directors, special committees and executives. He regularly works with inside and outside counsel, turnaround professionals, crisis management firms, investment and non-investment bank professionals, and DIP and exit financing lenders.

Rob's representative engagements span diverse industry segments that include health companies, retail, airline, housing, steel manufacturing, insurance, mortgage brokerage and consumer finance. He has worked on behalf of such companies as Security National Properties Funding III, LLC, RG Steel LLC, Maine Today Media, Trico Marine Services, Inc., and served as special counsel to DBSD North America, Inc. Representative engagements for board of directors/special committees and/or individual members on insolvency related matters include Pinnacle Airlines Corp., Riverstone Networks, Inc., Williams Communication, AOL Latin America Xybernaut Corporation and P&F Industries, Inc. Representative matters on behalf of other parties include the official equity committees in Syms Corp./Filenes Basement and Owens Corning Corporation, and ad hoc committees in NewPage Corporation, Bicent Power LLC, and Evergreen Solar, Inc.

A frequent speaker before business and professional audiences, Rob has addressed attendees at The Distressed Debt Conference, the Distressed Retail Summit: Turnarounds, Restructurings, Bankruptcies & Distressed Investing Conference, New York Institute of Credit/ABF Journal/TMA Philadelphia Conference, iiBIG's Alternative Investment All-Star Forum, Distressed M&A and Investments Summit, VALCON and at conferences coordinated by *the ABI Journal, the Norton Annual Survey of Bankruptcy Law, Global Restructuring Practice, and The Journal of Private Equity.*

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Best Practices in DIP Financing: The Entire Fairness Standard as it Applies to Equity Sponsors in Portfolio Company Bankruptcies

by: Robert J. Dehney, Matthew B. Harvey, and Andrew Roth-Moore,
Morris, Nichols, Arsht & Tunnell LLP[1]

For many distressed portfolio companies, an existing equity sponsor may be the only viable source of financing for a chapter 11 bankruptcy process. Because the equity sponsor is an insider with control over the debtor, however, bankruptcy courts have struggled with the proper standard to evaluate DIP financing provided by the debtor's equity sponsor.

The business judgment standard is the default standard for evaluating most transactions proposed by a debtor in bankruptcy. The business judgment standard is highly deferential and generally is satisfied if a transaction has some rational business purpose and is not the product of a grossly negligent decision-making process.[2] Ordinarily, "courts will almost always defer to the business judgment of a debtor in the selection of the lender."[3] When considering transactions involving a debtor's controlling insider, however, a bankruptcy court may elect to apply a heightened standard of review, such as the entire fairness standard which requires evidence of a fair price and fair dealing. Application of a heightened standard of review often occurs when the court is asked to approve a transaction on shortened notice in the early days of a chapter 11 case because the court has not been able to oversee the process to ensure its fairness. For this reason, it is more likely that a heightened standard of review will be applied to a request for DIP financing, approval of which is often sought at the outset of a case.

Bankruptcy Courts Rely on State Law Standards Governing Corporate Decision-Making[4]

For many transactions, the Bankruptcy Code does not express a standard of review. Following the Second Circuit's decision in *Lionel*,[5] bankruptcy courts typically adopt the standards of review for board decisions from state corporate law. For most transactions that do not involve an insider, the standard is the highly deferential business judgment standard. Bankruptcy courts may, however, apply a heightened standard of review—such as entire fairness—to transactions that benefit an insider. Because bankruptcy courts import these state court-derived standards, it is important to understand how the state courts have developed and applied these standards.

Business Judgment Standard

Under the business judgment standard, courts will not second guess a corporate decision, either prospectively by injunction or retrospectively by imposition of liability for damages, even if the board's decision ultimately proved unwise. The Delaware Supreme Court held "[t]he business judgment rule embodies the deference that is accorded to managerial decisions of a board of directors. Under normal circumstances, neither the courts nor the shareholders should interfere with the managerial decision of the directors."[6]

The business judgement standard is the default rule, and a court will apply a higher standard only if a plaintiff challenging the decision is able to rebut the presumption by showing that the board's decision was grossly negligent or not in furtherance of a rational business purpose. To do so, a plaintiff must "provid[e] evidence that directors, in reaching their challenged decision, breached any one of . . . their fiduciary dut[ies]."[7] Specifically, the plaintiff must show that (i) directors caused the company to execute a transaction in which the directors possess a direct or indirect personal interest, (ii) directors made a decision without reasonable awareness of all practically available material information or without prudent consideration of the alternatives, or (iii) directors did not act in good faith or in furtherance of a rational corporate purpose.

Thus, if the party challenging the decision "fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and . . . courts will not second-guess these business judgments.[8] If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."[9]

<u>Entire Fairness Standard</u>

When the party challenging a decision rebuts the presumption of the business judgment rule, courts apply the entire fairness standard. Under the entire fairness standard, the court will not presume that the transaction was appropriate; instead, the court will review the substance and surrounding circumstances of the transaction. The entire fairness standard applies to insider or conflicted transactions, in which a director stands on both sides of a deal (*i.e.*, approves a transaction benefiting the director).[10] Some courts may also apply the standard when a controlling shareholder indirectly influenced a board's decision to transfer some benefit to the controlling shareholder.

A court applying the entire fairness standard, as opposed to the business judgment standard, will conduct a thorough review of the challenged transaction. The initial burden is on the directors or controlling shareholder to prove that the transaction was the product of both a fair price and fair dealing.[11] Fair price relates to the economic and financial terms of the transaction and requires the court to value the transaction and determine whether the price achieved was fair. Fair dealing focuses on questions of process, particularly how the transaction was timed, initiated, structured, negotiated and disclosed, and how the approvals of the directors and the shareholders were obtained.

Bankruptcy Courts May Apply Entire Fairness When Reviewing Insider Transactions

Just as state courts apply a heightened level of scrutiny to insider or conflicted transactions, so may a bankruptcy court. A debtor's transactions with its equity sponsor is one of the areas most likely subject to heightened scrutiny from a bankruptcy court because the equity sponsor is often an insider with complete control over the debtor portfolio company's board. For example, in *In re Los Angeles Dodgers, LLC*, 457 B.R. 308 (Bankr. D. Del. 2011) (KG), the court found that a proposed DIP financing transaction was not entirely fair because it uniquely benefited the controlling shareholder at the expense of the bankruptcy estate. In this case, the debtors sought approval of DIP financing that was to be provided by a third party, Highbridge. The proposed financing transaction would have provided a significant benefit to the debtors' equity owner by relieving him from $5.25 million in personal debt. This personal benefit for the debtors' equity owner triggered entire fairness review. The court held the proposed transaction was not the product of fair dealing because the debtors "not only failed to attempt to obtain unsecured financing, they refused to engage [Major League] Baseball [, a willing alternative financing source,] in negotiations." The court also found that the debtors could not show fair price because financing was available from Major League Baseball on materially better terms. The court stated that Major League Baseball's "willingness to extend unsecured credit on better terms and Debtors' refusal to negotiate with [Major League] Baseball precludes a finding of entire fairness."

Similarly, in *In re UCI International, LLC*, Case No. 16-11354 (Bankr. D. Del.) (MFW), the court held that the proposed DIP financing from the debtors' controlling shareholder was not entirely fair. The debtors, an auto-parts company, were owned indirectly by Graeme Hart, whose holdings included another auto-parts company, AH Group. Before bankruptcy, the debtors and

AH Group were highly integrated, and AH Group supported many of the debtors' operations through various services agreements. Shortly before the petition date, however, AH Group unilaterally terminated many of these services agreements, allegedly at the direction of Mr. Hart.

After filing for chapter 11 protection, the debtors sought approval of a DIP financing transaction funded largely by Mr. Hart. As part of the DIP financing package, the Hart-controlled AH Group entities would extend the termination date of the services agreements and provide transition services—a benefit the debtors touted in exercise of their business judgment in entering into the DIP financing transaction. The debtors sought to insulate the DIP financing transaction from heightened scrutiny or entire fairness review by appointing an independent director who approved the transaction.

Notwithstanding the presence and approval of an independent director, the court applied entire fairness in reviewing the proposed DIP financing transaction because it found that the "history of transactions," including AH Group's termination of the services agreements, effectively limited the debtors' (and the independent director's) discretion to refuse the DIP financing transaction proposed by the controlling shareholder. The court remarked that "[y]ou can't screw up the debtor completely, and then appoint an independent director and make everything all right by letting the independent director have free reign in doing what he can to clean up the mess." In other words, by terminating the services agreements and then using the promise of continued services thereunder as inducement to enter into the DIP financing transaction, the controlling shareholder had set up circumstances where the debtors and the independent director had little choice but to accept the financing offered by the controlling shareholder. The court found that, under these facts, the DIP financing transaction should be evaluated under entire fairness even though it was approved by the independent director. The court then declined to approve the transaction, finding that it was the product of unfair dealing in how the proposed transaction was structured and negotiated.

In *In re Innkeepers USA Trust*, 442 B.R. 227 (Bankr. S.D.N.Y. 2010), the court also denied the debtors' requested relief on entire fairness grounds. Specifically, the court held that the debtors' proposed plan support agreement ("PSA") was not the product of fair dealing or a fair price because the PSA—in conjunction with a separate agreement made outside of the bankruptcy case—would have resulted in the debtors' parent retaining 50% of the debtors' equity.

Before the case filed, the debtor's parent investigated how to keep its equity position through a bankruptcy process. It began negotiating with Lehman, which held \$238 million of the debtors' \$1.5 billion in secured debt, and those negotiations resulted in a PSA between Lehman and the debtors. Under the PSA, the debtors would reorganize into a new entity, Lehman would exchange its debt for 100% of the new equity, and all secured creditors, other than Lehman, would have their existing debt exchanged for a new debt facility. In a side deal, Lehman agreed to subsequently transfer 50% of the new equity back to the parent.

The court took exception with both the debtors' negotiation process and the PSA's "price." With regard to process, the debtors' chief restructuring officer ("CRO") never shopped the PSA terms. In fact, until the PSA was filed with the bankruptcy court, the CRO had not disclosed to any third party the existence of the PSA (or the Lehman-parent deal). Additionally, the CRO did not take steps to determine whether the PSA offered a fair price—most notably, he never determined the value of the reorganized debtors' equity. As a result, the debtors did not have persuasive evidence to show that the PSA's "price" was fair. These shortcomings in the

CRO's efforts (combined with the significant value flowing to insiders) led the court to hold that the transaction did not satisfy the entire fairness standard.

The analyses in *Dodgers*, *UCI* and *Innkeepers* are illustrative of the circumstances that may trigger entire fairness review of a DIP financing transaction. In *Dodgers*, the transaction triggered entire fairness review because it provided a personal benefit to the controlling shareholder. The transaction was not approved because the price was not fair in light of a materially better competing proposal, nor was the process fair because the debtors failed to engage with other parties on alternative proposals. In *UCI*, the court applied entire fairness despite approval from an independent director because the court found that the controlling shareholder's conduct leading up to the transaction had effectively cornered the debtors into the controlling shareholder's proposal. In *Innkeepers*, the transaction could not satisfy the entire fairness standard because the debtors' CRO only negotiated with two insiders and offered no evidence that the process or price was fair to other stakeholders. These cases demonstrate the pitfalls of negotiating with an insider in a closed process and the importance of appointing an independent decision-maker who is fully empowered to negotiate on a debtor's behalf—and to do so early enough in the process that the independent party is not mere window-dressing on a decision that is *fait accompli*.

<u>*Bankruptcy Courts May Also Apply Heightened Scrutiny When Reviewing Insider Transactions*</u>

In addition to entire fairness, some bankruptcy courts have applied other intermediate forms of heightened scrutiny to insider transactions.[12] For example, in *TerreStar Networks Inc.*, Case No. 10-15446 (Bankr. S.D.N.Y.), the court applied an intermediate level of heightened scrutiny when reviewing and ultimately approving a DIP financing proposal by minority shareholder, EchoStar. EchoStar held roughly 15% of the debtor's equity and a large portion of multiple debt instruments. Importantly, the EchoStar equity rights included a "black marble" provision that allowed EchoStar to veto certain major corporate actions.

Until a few months prior to filing, the debtor, pursuant to an agreement with a third party, was prohibited from negotiating any transaction involving its most valuable asset. Thus, the debtor entered bankruptcy without having extensively shopped itself. On the petition date, the debtor proposed to enter a restructuring support agreement ("RSA") with EchoStar, and in conjunction with the RSA, EchoStar also offered the debtor a DIP facility. Under the RSA,[13] EchoStar would receive a large portion (but less than half) of the reorganized debtor's preferred and common stock, retain much of its prepetition debt and backstop the majority of a rights offering.

Several stakeholders objected to the DIP financing transaction, arguing that the deal with EchoStar constituted an insider transaction that should be reviewed under the entire fairness standard. The court disagreed, stating that the objectors had not shown sufficient evidence that EchoStar controlled the debtor's decision to enter into the transaction. Thus, the court declined to require entire fairness review. Nonetheless, given the benefit the transaction provided to EchoStar as an insider, the court also declined to apply the deferential business judgment standard.

Rather, the court applied what it called, "for lack of a better term . . . some heightened scrutiny."[14] The court subsequently described the standard as giving "special attention . . . to the circumstances surrounding EchoStar."[15] Although the court did not elaborate on the additional scrutiny applied, *TerreStar* illustrates that a bankruptcy court may give added attention to an insider transaction even if the transaction would not trigger entire fairness review under state law. The same proactive measures discussed below that may insulate a transaction from entire fairness review should also be useful in avoiding or satisfying intermediate forms of heightened scrutiny where an insider benefits from the transaction but did not control the transaction in a strict sense.

Insulating a Transaction from Entire Fairness Review

As discussed above, the entire fairness standard is more exacting than review under the business judgment rule and, if applied, creates an enhanced risk that a transaction may not be approved. The existence of this standard, however, does not preclude a debtor from entering into a transaction with an insider. As the *TerreStar* court noted, a transaction is not considered an insider transaction and subjected to entire fairness review merely because an insider receives some benefit. Rather, a transaction is an "insider transaction" when there is a party on both sides of a deal that (i) has the power, either directly or indirectly, to control the actions of a debtor and (ii) actually exercises that power.

Although there are other ways to demonstrate that an insider did not control a deal and thus avoid the application of entire fairness, appointing and empowering an independent director to oversee transactions involving conflicted insiders is the favored approach among many courts and professionals. For example, in *In re Station Casino Inc.*, Case No. 09-52477 (Bankr. D. Nev.), the court approved a transaction that would transfer substantially all of the debtors' hotel-casinos to a newly formed entity owned by the debtors' controlling insiders, the Fertitta family. The debtors proposed the transaction in two stages. First, the debtors would sell eleven of their hotel-casinos through a section 363 sale, with the newly formed Fertitta-controlled company serving as the stalking horse bidder. Second, through a chapter 11 plan, the debtors would transfer to the new Fertitta-controlled company the majority of their remaining assets.

The most significant fight in the case revolved around the debtors' proposed sale procedures. Several parties opposed the procedures, including the debtors' largest market competitor, which had been passed over as a potential stalking horse bidder in favor of the Fertittas, and creditor groups, which argued that the division of assets drove down the price.

Ultimately, the court approved the sale procedures. While the court did not state what standard it applied in reaching its decision, it appears that two facts were most significant to the court's ruling: (i) the debtors' independent director would oversee and control the auction; and (ii) the court believed that the Fertittas' stalking horse bid was negotiated at arm's length by the independent director. By empowering the independent director to negotiate the best deal for the debtors, the debtors successfully insulated the transaction from a higher standard of review.

Similarly, in *In re Residential Capital, LLC*, 2013 WL 3286198 (Bankr. S.D.N.Y. July 27, 2013), the court applied the deferential business judgment standard in reviewing a transaction between the debtors and their controlling shareholder because, among other reasons, an independent decision-maker negotiated and approved the transaction on behalf of the debtors. In that case, the debtors filed a motion to assume a PSA with several parties, including their indirect parent, Ally Financial, the creditors' committee and certain consenting claimants. Several constituents objected, arguing that the court should apply the entire fairness standard because the PSA transferred assets to insiders. The court disagreed.

The court noted that the PSA was the result of a court-supervised mediation process. After the debtors sold their assets, the debtors, Ally, the creditors' committee and certain other claimants entered into mediation to resolve the significant remaining disputes. During the mediation, the debtors were represented by a CRO that was not beholden to Ally. Based on that record, the court determined that the negotiations which led to the PSA were conducted in good faith. As a result, the court concluded that the business judgment standard was appropriate.

The divergent results from using independents in *Station* and *Residential Capital* compared to *UCI* provide an instructive contrast in how to best insulate a transaction from entire fairness review. In *Station*, the independent director was fully and timely empowered and could negotiate at arm's length with the controlling shareholder. In *Residential Capital*, an independent CRO was fully empowered and vested with negotiating authority by the debtors. Therefore, in *Station* and *Residential Capital*, appointing and empowering an independent party to oversee the process effectively insulated the transactions from entire fairness review or heightened scrutiny. In contrast, in *UCI*, the independent director was not in place until it was too late for the independent director to meaningfully negotiate. Thus, the use of an independent director in *UCI* failed to insulate the transaction from entire fairness review.

UCI also highlights that appointing an independent decision-maker, standing alone, will not insulate a transaction from entire fairness review. Rather, the independent decision-maker must be fully empowered and appointed early enough in the process to be able to meaningfully exercise that power. In *Station*, *Residential Capital* and *UCI*, the courts each noted the specific decisions or process that the independent party controlled or did not control. The courts defer to a debtor's decisions when the independent party had appropriate decision making authority during the outcome-determinative stage of negotiations, but not when the independent decision-maker was left handcuffed by prior acts of the controlling shareholder over which the independent decision-maker had no say.

A Note on Limited Liability Companies and Other Alternative Entities

Many states' laws permit provisions curtailing or eliminating fiduciary duties in limited liability company agreements or similar alternative entity agreements, such as eliminating the duty of loyalty and allowing a member to engage in self-interested transactions. These provisions raise the question of whether a bankruptcy court would enforce a fiduciary duty waiver so as to allow for a lower standard of review. For example, if a debtor's LLC agreement eliminated the duty of loyalty and allowed members to engage in interested transactions, would that provision preclude a bankruptcy court from entire fairness review of an interested transaction? Although there are no cases directly on point, the bankruptcy court's holding in *In re Houston Regional Sports Network, L.P.*, 505 B.R. 468 (Bankr. S.D. Tex. 2014) suggests that such a waiver would not eliminate the possibility of entire fairness review.

The debtor in the case, Houston Regional Sports Network (the "Network"), a Delaware limited partnership, was a failing joint venture television network between the Houston Astros, the Houston Rockets, and Comcast. Affiliates of Comcast and the Network filed an involuntary petition against the Network. The Astros opposed the filing, however, arguing that the Network's partnership agreement gave the Astros the authority to block any reorganization efforts.

The Astros controlled one member sitting on the board of the Network's general partner. Pursuant to the Network's partnership agreement, that Astros member had an absolute right to veto major decisions, including a reorganization or asset sale. Further, the Astros board member was expressly permitted to exercise the veto right in the Astros' best interest, without regard to the interests of the partnership. The Astros argued that it could, and would, use this power to block any bankruptcy reorganization, and, as a result, the case should be dismissed as futile.

The court disagreed and held that once an entity came into bankruptcy, the individuals or entities that manage the debtor, "whether officers and managing employees or puppeteers acting through a general partner" are bound to "assume[] the fiduciary duties of the chapter 7 trustee."[16] Thus, no provision in a debtor's organizational documents can excuse those fiduciary duties. The Astros and its board member could not arbitrarily reject any bankruptcy reorganization or other restructuring deal.

Houston Regional Sports stands for the proposition that provisions limiting fiduciary duties do not have the same effect in bankruptcy. Although not directly on point as to standards of review, the reasoning of *Houston Regional Sports* suggests that a bankruptcy court may still apply entire fairness or heightened scrutiny to an insider transaction even where such transactions are permitted in the debtor's operative agreements.

Conclusion – Best Practices

As discussed, appointing and fully empowering an independent decision-maker to negotiate, shop and manage an insider transaction is the best practice to help avoid entire fairness review or other heightened scrutiny. Appointing an independent party may only shield a transaction from scrutiny if the independent party is meaningfully involved in the process. Meaningful involvement depends on whether the party (i) had the time and resources to gather information regarding the transaction, (ii) was free to negotiate with the insider *and* third parties, (iii) had independent authority to finalize a transaction, and (iv) became involved in the process at a point when the debtor still had the option to work with a non-insider.

A robust and thoughtful process is also necessary because the process must not only be fair, it must appear fair.[17] Appointing and empowering an independent decision-maker does little good if the independent party fails to run a meaningful process to seek out and evaluate alternatives. Building a strong record of the process and the arm's length negotiations between debtor and insider is key to later satisfying any evidentiary burden to avoid or satisfy entire fairness.

In re Los Angeles Dodgers LLC, 457 B.R. 308 (Bankr. D. Del. 2011) (KG)

The Dodgers sought the approval of a DIP loan from Highbridge despite the existence of a materially better DIP loan offered by Major League Baseball.

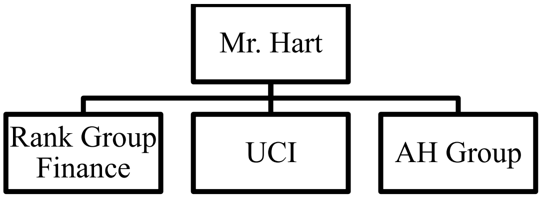
COMPARISON OF MATERIAL DIP TERMS

	Highbridge DIP Facility	MLB DIP Facility
Fees:	0.50% Delayed Draw Fee $4.5 MM Deferred Comm Fee $5.25 MM Closing Comm Fee $50,000 Annual Agent Fee	None
Interest Rate:	LIBOR + 6% (3% Floor) Base Rate + 6.0%	LIBOR + 5.5% (1.5% Floor) Base Rate + 4.5%
Security:	All Estate Assets	Unsecured
Priority:	Super-Priority Administrative	Administrative
Events of Default:	Case Dismissal Trustee or Examiner Appointed Termination of certain agreements with MLB	Less onerous events of default
Maturity Date:	June 27, 2012	November 30, 2012
Benefits for Frank McCourt	McCourt would be relieved of $5.25M of personal debt	McCourt more likely to lose control of the team

The court reviewed the transaction under the entire fairness standard because the deal with Highbridge served the interests of the Dodgers' owner, Mr. McCourt (notably, the relief of $5.25M in personal debt). The court found that the "Debtors not only failed to attempt to obtain unsecured financing, they refused to engage Baseball in negotiations." The court then concluded that, Major League Baseball's "willingness to extend unsecured credit on better terms and Debtors' refusal to negotiate with Baseball precludes a finding of entire fairness." *Dodgers*, 457 B.R. at 314.

In re UCI International, LLC,
Case No. 16-11354 (Bankr. D. Del.) (MFW)

Prepetition Capital Structure



* The operations of UCI and non-debtor AH Group were heavily integrated

** Rank Group Finance has a close relationship with Credit Suisse, investing in numerous joint projects

Timeline: Hart's attempt to separate AH Group from UCI to avoid UCI liabilities

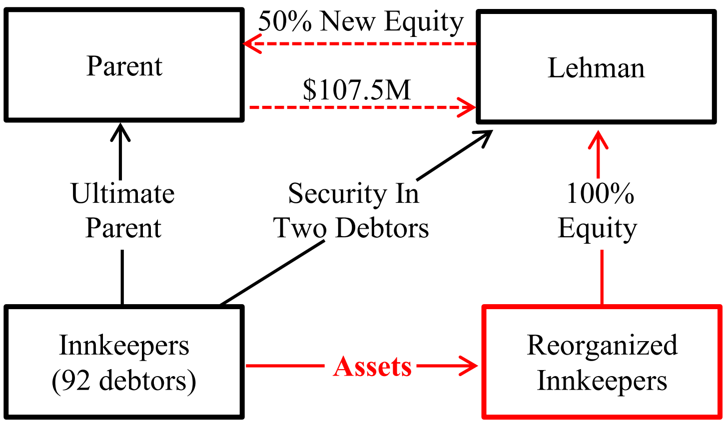
July 2015	Credit Suisse issued an ABL to UCI
Dec 2015	Credit Suisse transferred a large portion of the ABL to Rank Group Finance
Feb 2016	Independent director appointed to the UCI board (but not given authority over many decisions until the bankruptcy filing)
May 2016	AH Group begins to cancel joint service agreement with UCI
	Other UCI counterparties begin issuing notices of termination

Competing DIP Facilities

Rank and Credit Suisse:	100% roll-up of prepetition ABL upon close.
Ad hoc noteholder group:	Wedge DIP priming Rank's ABL position, but not Credit Suisse's ABL position.
	Credit Suisse would not support this DIP, citing its relationship with Rank Group Finance.

The court reviewed the Rank/Credit Suisse DIP under the entire fairness standard because of "the history of transactions" that occurred both pre- and postpetition. The court was unpersuaded that the appointment of an independent director meant that the court should apply the business judgment standard: "You can't screw up the debtor completely, and then appoint an independent director and make everything all right, by letting the independent director have free reign in doing what it can to clean up the mess."

In re Innkeepers USA Trust, 442 B.R. 227 (Bankr. S.D.N.Y. 2010)



*Lehman held $238 million in mortgages against two debtors
**The debtors had roughly $1.5 billion in total secured debt

Relevant Facts: Parent's secret deal to keep control

Parent begins exploring strategies to maintain its equity through a bankruptcy process

PSA between Innkeepers and Lehman

- Innkeepers will transfer its assets to New Innkeepers
- In satisfaction of its mortgages, Lehman will receive 100% of New Innkeepers equity
- Other secured lenders will receive new loans

Side Deal: Lehman agrees sell Parent 50% of New Innkeepers equity

Innkeepers did not disclose the existence of the side deal or the PSA to creditors

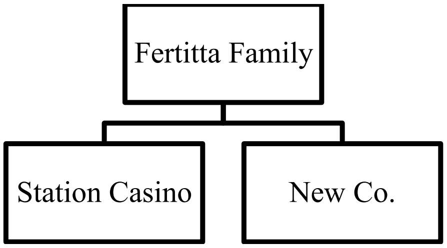
Innkeepers moves under section 365 to approve the PSA

The court denied the motion to approve the PSA based primarily on the flawed negotiation process. The court noted that, because the record showed that Parent and Lehman exercised tremendous control over the debtors' decisions, "the heightened scrutiny/entire fairness standard . . . may apply." It declined, however, to decide whether heightened scrutiny should apply because it found that the transaction failed to meet even the business judgment standard.

The court, nonetheless, examined the transaction using the entire fairness standard. It found that the process was not fair because: (i) the debtors never "shopped the term sheet" to any other party; (ii) the debtors did not determine a value of the new Innkeepers' equity; and (iii) the PSA had a strict no talk provision. Further, the court could not find that the price was fair because the debtors presented no competent evidence or testimony regarding the value of the new equity.

In re Station Casino Inc., Case No. 09-52477 (Bankr. D. Nev. 2009)

The court approved procedures for a two-step transaction that would likely result in the debtors' casino-hotels being retained by the controlling shareholder, the Fertitta family.



Section 363 Sale (transfer half the assets)

- Stalking Horse: New Co.
- Overseen by an independent director.

Plan

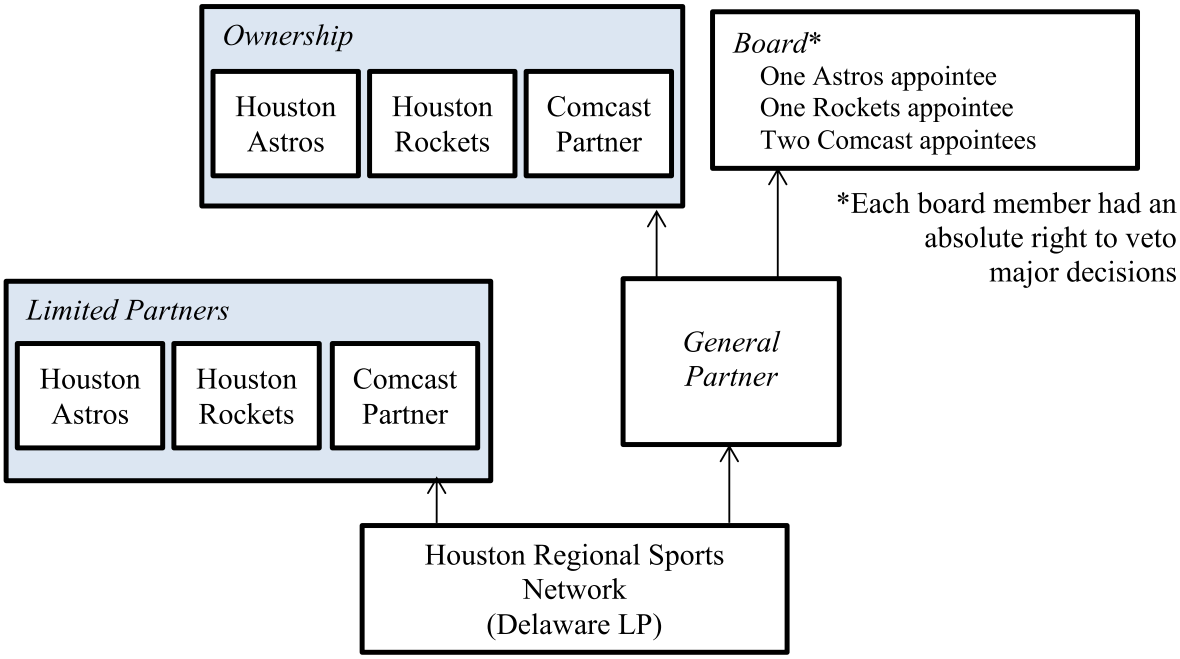
- Remaining assets transferred to New Co.

The debtors proposed to sell half of their properties through a 363 process. A newly formed entity, controlled by the Fertitta family, would serve as the stalking horse. The other half of the properties, and certain other assets, would be transferred to the Fertitta's new company through a plan. Notably, the assets to be transferred through the plan included certain IP (*e.g.*, customer lists) beneficial to operating the properties being sold in the 363 sale.

The court approved the sale procedures, finding significant that the auction would be controlled by the debtors' independent director and that the new Fertitta-controlled entity was selected as the stalking horse bidder only after meaningful, arm's-length negotiations conducted by the independent director with the Fertittas and third parties

Houston Reg'l Sports Network, L.P., 505 B.R. 468 (Bankr. S.D. Tex. 2014)

One of the debtor's limited partners, the Houston Astros, unsuccessfully argued that, based on its rights under a partnership agreement, it could block the debtor from taking any major action (e.g., DIP, 363, or plan) without regard to interests of the debtor or other members.



The Houston Regional Sports Network, a Delaware limited partnership, was a failing joint venture. Under the Network's limited partnership agreement, each board member had an absolute right to veto major decisions, including a reorganization or asset sale. The board members were expressly permitted to exercise the veto right in their best interest, without regard to any fiduciary duty to the partnership.

Nearly every major constituent other than the Houston Astros filed an involuntary petition against the Network. The Astros felt that, with more time, the Network could be profitable. The Astros filed a motion to dismiss the petition arguing that the petition was futile because its board member could and would reject any reorganization effort, without regard to the Network's interests.

The court disagreed. It held that, once an entity came into bankruptcy, the individuals or entities that manage the debtor, "whether officers and managing employees or puppeteers acting through a general partner" are bound to "assume the fiduciary duties of the chapter 7 trustee." No state law or contractual provision can excuse such an individual or entity from that fiduciary duty. *Houston Regional Sports*, 505 B.R. at 481–82.

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[2] *See Sinclair Oil Corp. v. Levien*, 280 A.2d 171, 720 (Del. 1999); *In re Zale Corp. S'holders Litig.*, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015).

[3] *In re Los Angeles Dodgers LLC*, 457 B.R. 308, 314 (Bankr. D. Del. 2011) (KG).

[4] This section discusses Delaware corporate law.

[5] *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983).

[6] *Omnicare, Inc. v. NCS Healthcare, Inc*., 818 A.2d 914, 928 (Del. 2003) (citations omitted).

[7] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *Citron v. Fairchild Camera & Instr. Corp.*, 569 A.2d 53, 64 (Del. 1989)).

[8] *See Citron v. Fairchild Camera & Instr. Corp.*, 569 A.2d 53, 64 (Del. 1989); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

[9] *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citing *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. Supr. 1993); *Mills Acq. Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989); *Weinberger v. UOP, Inc*., 457 A.2d 701, 710 (Del. Supr. 1983)).

[10] *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361–62 (Del. 1993) (stating the purpose of the entire fairness standard is to shift the burden of proof from the plaintiff to the defendant directors); *Kahn v. Lynch Commc'n Sys.*, *Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (applying entire fairness standard in context of interested merger); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness.").

[11] *Orman v. Cullman*, 794 A.2d 5, 21 (Del. Ch. 2002).

[12] Under Delaware corporate law, an intermediate form of enhanced scrutiny applies in certain situations, such as when a board adopts defensive measures or responds to a takeover proposal. *See generally Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) and its progeny. It is not clear, however, that a bankruptcy court would necessarily rely on or import this precedent developed in the nonbankruptcy corporate context.

[13] The debtors ultimately voluntarily withdrew the RSA motion.

[14] *In re TerreStar Networks Inc.*, Case No. 10-15446 (Bankr. S.D.N.Y. Nov. 16, 2010), hr'g tr. at 229.

[15] *Id*.

[16] *In re Houston Reg'l Sports Network, L.P.*, 505 B.R. 468, 481–82 (Bankr. S.D. Tex. 2014)

[17] *In re Innkeepers USA Trust*, 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010).

Secured Lender Case Protections in DIP Orders vs. Cash Collateral Orders

DECEMBER 2, 2016

Overview

- **DIP Orders and Cash Collateral Orders Achieve Different Things**
  - A "**DIP Order**" ordinarily:
    - authorizes a debtor to enter into a DIP credit agreement
    - includes important terms and conditions governing the above
    - incorporates the DIP credit agreement, the terms and conditions of which are the focus of most of the negotiations
  - A "**Cash Collateral Order**" ordinarily:
    - authorizes a debtor to use the cash collateral of its prepetition secured lenders
    - includes important terms and conditions governing the above
    - is independent of any DIP credit agreement (though certain terms of the prepetition credit agreement can be incorporated into the Cash Collateral Order)
- **Prepetition Secured Lenders Often Provide DIP Financing, Merging the Two Orders**
  - If a debtor obtains DIP financing from its prepetition secured lenders, the cash collateral provisions are built into the DIP Order itself
  - However, if no new DIP financing is provided, the prepetition secured lenders can obtain case protections only from the Cash Collateral Order
    - Note that, in most cases, having a stand-alone Cash Collateral Order likely means that no new DIP financing is being provided, because obtaining first priority DIP financing from lenders other than the prepetition secured lenders would generally entail a priming fight, which debtors tend to avoid
- **Even though use of cash collateral is a form of financing, because it does not entail any "new money", the powers and protections in a Cash Collateral Order will be more limited than in a typical DIP Order**

Fundamental Case Protections

Protection	DIP Order	Cash Collateral Order
Cram-Up Protection (Roll-Up)	More likely	No
Milestones	Yes	Less likely
Approval Rights on Motions & Filings	Yes	Less likely

- **Because new money is provided in a DIP financing, a DIP Order will almost always provide for stronger fundamental case protections**
- **To further their interests throughout a case, DIP lenders have more direct levers in the DIP Order or DIP credit agreement, while prepetition secured lenders under a Cash Collateral Order more likely have only objections or threats of objections**

Important Case Protections

- **However, secured lenders consenting to use of cash collateral can obtain important case protections (ordinarily found in DIP credit agreements) offering a degree of comfort and visibility into the case**

Protection	DIP Order	Cash Collateral Order
Preservation of Collateral Cushion	Possible	Possible
Cash Sweeps of Excess Cash or Sale Proceeds	Yes, normally in DIP Credit Agreement	Yes
Enhanced Collateral and Other Reporting Requirements	Yes, normally in DIP Credit Agreement	Yes
Financial Covenants / Budget	Yes, normally in DIP Credit Agreement	Yes

Other Protections

Protection	DIP Order	Cash Collateral Order
Postpetition Superpriority Liens & Claims	Yes	No, because no new money provided
Limitation on Use of Proceeds / Cash Collateral	Yes	Limitation on use to investigate / litigate against prepetition secured lenders, but no general limitation
Adequate Protection Liens & Claims	Yes	Yes
Events of Default	More Extensive	Less Extensive
Lifting of Automatic Stay as Remedy after Event of Default	Yes, upon finding that EoD occurred	No, debtor may seek non-consensual use of cash collateral despite EoD
364(e) "Good Faith" Protection	Yes	N/A
Indemnification of DIP Agent	Yes	N/A
Waiver of Filing PoC	Yes	Yes
Carve-Out	Yes	Yes
506(c), Marshaling, 552(b) Equities of the Case Waivers	Yes	Yes

Conclusion

- **Counsel to a secured lender obtaining only Cash Collateral Order protections must find creative ways to fill in the "*delta*" between protections offered in a DIP Order and DIP credit agreement on the one hand, and in a stand-alone Cash Collateral Order on the other**
- **To close the delta, counsel must bargain for additional provisions in the Cash Collateral Order that would typically be found in a DIP credit agreement**
  - Affirmative Covenants
  - Negative Covenants
  - Termination Provisions
  - Events of Default
- **However, the background negotiating context for DIP Orders and Cash Collateral Orders is fundamentally different, diminishing the leverage of prepetition secured lender not providing DIP financing**
  - In negotiating DIP Orders, the debtor needs money, and the fall-back option if it cannot agree to terms with its DIP lenders is *to liquidate*
  - In negotiating Cash Collateral Orders, the debtor does not immediately need money, and the fall-back option if it cannot agree to terms with its prepetition secured lenders is *to seek court approval for non-consensual use of cash collateral*
  - Whereas a court cannot force a DIP lender to lend, it can find ways to determine that adequate protection exists to allow for non-consensual use of cash collateral
- **Therefore, as a practical matter, secured lenders will not be able to fully replicate the DIP credit agreement within the Cash Collateral Order**

Adequate Protection Packages, Common Creditors' Committee Objections and Competing DIPs

Damian S. Schaible *

I. Introduction/Executive Summary

A. Defensive DIP Financings: Prepetition secured lenders often provide debtor-in-possession (DIP) financing to debtors in chapter 11 bankruptcy proceedings to protect their existing credit exposure to the debtors and avoid the priming of their claims, with insufficient adequate protection, by other providers of post-petition financing. Their extension of credit, however, comes with many significant risks. The new money they provide to fund the debtors' liquidity will prime their own prepetition loans, and the debtor's continued operation will require use of cash collateral. To induce prepetition lenders to provide DIP financing in light of such risks, debtors have been willing to engage in an exchange of value with lenders whereby, in exchange for the new money financing, debtors offer various sources of value, including adequate protection packages, 506(c) waivers, liens on avoidance action proceeds and marshaling waivers. DIP lenders also typically stipulate a budget and deadline for challenges from the unsecured creditors' committee (UCC).

B. UCC Objections to Proposed DIP Orders: UCCs are typically concerned that defensive DIP financings may be on excessively onerous terms or that prepetition lenders may exert too much control over the debtor with the threat of withholding consent to the use of cash collateral. Committees may also be concerned that better terms for the company could be obtained if there are significant unencumbered assets. These concerns, if not resolved in private negotiations with the debtor and secured lenders, often lead to a set of typical

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objections to DIP financings. The objections push a narrative that the DIP financing is unnecessary or too large and does not merit the consideration provided to the DIP lenders. Certain of the disputes giving rise to these common objections are profiled below in Section II. Secured lenders will often emphasize that the UCC has cherry picked provisions that should be considered in light of the entire, heavily negotiated package with the debtors. Counsel for the UCC may point to instances in which courts have "stared down" DIP lenders and denied certain of their requests for the DIP order, in essence daring them not to provide the financing.

C. Competing DIP Financings: The presence of unencumbered assets is one of a few circumstances that could induce parties to provide a competing DIP financing option to the debtors. Other circumstances, such as if junior creditors desire greater influence on the chapter 11 cases and the plan of reorganization, may also induce competitive bids to provide DIP financing. Secured creditors are often the best (or only viable) source of DIP financing, but the existence of other options will necessitate the debtor's defense of its exercise of business judgment in choosing one option over another.

II. Common Disputes with the UCC [1]

A. Adequate Protection

1. The Bankruptcy Code does not explicitly define "adequate protection" but the Code does state that adequate protection of a secured party's interest in property may be provided by:

a) requiring the debtor to make a cash payment or periodic cash payments to the extent of diminution of collateral;

[1] These disputes represent only a small subset of the issues that commonly arise in a DIP negotiation with a UCC, though they represent some of the most common or otherwise most difficult to resolve. Other potential disputes may arise over cross collateralization, the challenge deadline or a proposed "roll up" of prepetition debt into the DIP facility.

b) providing to such entity an additional or replacement lien to the extent of diminution; or

c) granting such other relief, other than entitling such entity to compensation allowable as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.[2]

2. The package of protections provided to prepetition lenders in exchange for their consent to being primed and for the use of their cash collateral often includes, among other things:

a) a junior priming lien on all assets, to the extent of diminution;

b) a junior superpriority claim, to the extent of diminution;

c) current cash interest; and

d) professional fees.

3. Typically DIP lenders will insist on being secured by:

a) a priming lien at least on all inventory, receivables and cash;

b) either a priming or a second lien on other encumbered property; and

[2] *See In re Scopac*, 624 F.3d 274 (5th Cir. 2010) ("'Adequate protection' is a term of art in bankruptcy practice, defined in 11 U.S.C. § 361 and applied in §§ 362(d) and 363(e); in short, it is a payment, replacement lien, or other relief sufficient to protect the creditor against diminution in the value of his collateral during the bankruptcy."). *See also In re O'Connor*, 808 F.2d 1393 (10th Cir. 1987) ("The whole purpose in providing adequate protection for a creditor is to insure that the creditor receives the value for which the creditor bargained prebankruptcy. House Rep. No. 95–595, 95th Cong., 2d Sess. 53, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5963, 6295. In determining these values, the courts have considered 'adequate protection' a concept which is to be decided flexibly on the proverbial 'case-by-case' basis.").

c) a first priority lien on debtor's unencumbered property.

4. Not only are adequate protection payments specifically referenced by statute, but they also have solid basis in case law.[3] They are routinely granted as part of adequate protection packages in DIP orders, often at the non-default contract rate of interest.

5. UCCs may challenge adequate protection payments and assert that replacement liens are sufficient adequate protection, or that the lenders are receiving sufficient adequate protection solely from the debtors' continued operation of their businesses.

a) In the absence of secured lender consent, the debtor bears the burden of proving that the secured creditor is adequately protected.[4]

b) Generally, debtors will negotiate for the consensual use of prepetition collateral to avoid the expense and distraction of a fight over this issue in the early days of the bankruptcy case. Thus, the secured lenders will assert that they are entitled to adequate protection payments as consideration for their consent to the use of their collateral.

6. An issue may arise as to whether the adequate protection payments constitute interest payments (to which only oversecured creditors would be entitled) or a pay down of principal. Final DIP orders that allow for recharacterization of adequate protection payments, in the event, for example, that secured creditors are undersecured, provide a strong

[3] *See, e.g.*, *In re 354 E. 66th St. Realty Corp.*, 177 B.R. 776, 782 (Bankr. E.D.N.Y. 1995) ("The purpose or intent of granting adequate protection payments are to maintain the status quo for that creditor and to protect the creditor from diminution or loss of the value of its collateral during the ongoing Chapter 11 case.").

[4] *See* 11 U.S.C. § 363(p) ("In any hearing under this section [] the trustee has the burden of proof on the issue of adequate protection.").

argument that adequate protection payments do not unfairly prejudice unsecured creditors.

B. Marshaling

1. The marshaling doctrine is an equitable remedy whereby a court may require a secured creditor to first satisfy its claim from property of the debtor in which a junior creditor lacks an interest—thus protecting the junior creditors' interest in property subject to both a senior and junior claim.

2. Requiring a "no marshaling" provision as a condition to providing DIP financing is a common, powerful strategy for prepetition secured lenders that enables them to preserve collateral for their prepetition claims, while using unencumbered assets to fund the DIP claims.

3. Though marshaling waivers are clearly the market norm in DIP financings, they regularly elicit opposition from UCCs. In contesting the marshaling waiver, unsecured creditors are employing a distortion of the marshaling doctrine, seeking to force the satisfaction of the DIP lenders' claims from collateral of other secured lenders in order to preserve value for unsecured creditors.

4. As a general rule, only secured creditors have standing to object to a marshaling waiver.[5] However, some UCCs have cited to case law where courts allowed the debtor in possession, as hypothetical lien creditors under section 544(a) of the Bankruptcy Code, to invoke the marshaling doctrine for the benefit of unsecured creditors in support of their

[5] *See Galey & Lord, Inc. v. Arley Corp.* (*In re Arlco, Inc.*), 239 B.R. 261, 274 (Bankr. S.D.N.Y. 1999) (holding that unsecured creditors have no right to invoke the doctrine of marshaling) (citing *Herkimer Cnty. Tr. Co. v. Swimelar* (*In re Prichard*), 170 B.R. 41, 45 (Bankr. N.D.N.Y. 1994)).

objection.[6] They have cited to cases where courts have stated that the "equities" of a situation demand marshaling.[7]

a) That a trustee or debtor in possession may invoke marshaling does not strip its ability to waive the invocation of marshaling in exchange for the provision of DIP financing, and it also does not provide unsecured creditors standing to object to such a waiver.[8]

b) Cases that appear to have expanded the doctrine of marshaling in respect of unsecured creditors for equitable reasons have generally not been followed and in some cases have been criticized.[9] These cases typically involve circumstances where a secured creditor has recourse to assets both inside and outside the estate.[10] But this is often not the case when the UCC is objecting to a waiver.

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[6] Cases cited for the proposition that the debtor in possession may invoke marshaling include *Kittay v. Atlantic Bank (In re Global Service Group LLC)*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004) (reasoning that debtor can invoke marshaling by virtue of its status as a hypothetical lien creditor under Section 544(a) of the Bankruptcy Code).

[7] *Berman v. Green (In re Jack Green's Fashions for Men Big & Tall, Inc.*), 597 F.2d 130 (8th Cir. 1979) (holding that equities of the case demand marshaling), which was decided under the pre-1978 Bankruptcy Act, and *Matter of Clary House, Inc.*, 11 B.R. 462 (Bankr. W.D. Mo. 1981) (same).

[8] *See In re America's Hobby Ctr., Inc.*, 223 B.R. 275, 288 n.6 (Bankr. S.D.N.Y. 1998) ("[O]nly a trustee may assert [marshaling] as a hypothetical execution creditor and an unsecured creditor has no standing to do so.").

[9] *See UPS Capital Bus. Credit v. C.R. Cable Constr., Inc.*, 181 S.W.3d 44, 48 (Ky. Ct. App. 2005) ("*Clary House* is an anomaly which has not been followed by any other court . . . ."); *Robert E. Derecktor*, 150 B.R. at 300 ("[*Berman* has] been criticized as improperly extending the traditional scope of the marshaling doctrine").

[10] *See Kittay*, 316 B.R. at 463-64; *Berman*, 597 F.2d at 133; *Clary House*, 11 B.R. at 466.

c) Courts have also rejected the reasoning that potential harm to the recovery of unsecured creditors is sufficient justification to reject marshaling waivers.[11]

5. A frequent compromise to disputes over marshaling is a "soft marshaling" provision whereby a secured creditor agrees to use commercially reasonable efforts (or a similar standard) to satisfy claims from its own collateral before it resorts to unencumbered assets.

C. 506(c) Waivers

1. Pursuant to section 506(c), a debtor may recover from (surcharge) collateral any reasonable and necessary expenses of preserving or disposing of the property, to the extent that the secured creditor received any benefit.

a) As a general rule, 506(c) is understood as granting exclusive standing to the trustee or debtor in possession, at least in the first instance, to bring a claim under section 506(c).[12]

b) 506(c) waivers are very routinely allowed in DIP orders over UCC objections; the potential exercise of 506(c) surcharges is seen as valuable consideration that the debtors can cede in exchange for commitments to DIP financing.

c) However, there is case law in some jurisdictions that suggests that such waivers should be unenforceable.[13]

[11] *See, e.g.*, *In re Robert E. Derecktor of R.I., Inc.*, 150 B.R. 296, 300 (Bankr. D.R.I. 1993) (noting that "[i]f we were to accept the unsecured creditors' argument regarding prejudice, the doctrine of marshaling would rarely, if ever, be utilized in bankruptcy because its application almost always results in diminished assets for the unsecured creditors.").

[12] *See Hartford Underwriters Ins. Co. v. Union Planters Bank*, N.A., 530 U.S. 1 (2000); *In re River Ctr. Holdings, LLC*, 394 B.R. 704, 717 (Bankr. S.D.N.Y. 2008) ("The Supreme Court has made clear that only the trustee has the power, under the plain language of the Code, to assert a section 506(c) claim.").

2. Because some case law holds that a surcharges against prepetition collateral are intended to benefit the estate generally,[14] if DIP lenders have a superpriority claim it may be considered pointless to surcharge in the context of a defensive DIP.[15]

D. UCC Fee Caps

1. UCC fee budgets are established via a "carve-out" in the DIP order.

a) The fee cap allows for fees up to a budgeted amount to be paid out of prepetition lenders' cash collateral.

b) Where a prepetition secured creditor has a lien on all or substantially all assets, courts generally treat carve-outs as the "price of admission" to bankruptcy court where a secured creditor benefits from the preservation of the estate.[16]

c) For fees and expenses above the amount set forth in the carve-out, UCCs can typically submit an administrative claim, subject to the requirements in the Code that such fees and expenses be "actual and necessary" for the preservation of the estate.

(continued….)

[13] *Compare In re Ridgeline Structures, Inc.*, 154 B.R. 831, 832 (Bankr. D. N.H. 1993) (denying approval of a section 506(c) waiver in a cash collateral order that was to apply "no matter what action, inaction, or acquiescence" by the secured creditor might have occurred stating that such a waiver is against public policy and is unenforceable per se) *with In re InteliQuest Media Corp.*, 326 B.R. 825, 832 (10th Cir. B.A.P. 2005) (affirming on res judicata grounds a bankruptcy court's order that enforced section 506(c) waivers) *and In re Film Equipment Rental Co*., 1991 U.S. Dist. LEXIS 17956 (S.D.N.Y. 1991) (enforcing a section 506(c) waiver in a cash collateral order).

[14] *See, e.g.*, In re K&L Lakeland, Inc., 128 F.3d 203 (4th Cir. 1997).

[15] *See, e.g.*, *In re JKJ Chevrolet, Inc.*, 26 F.3d 481 (4th Cir. 1994); *In re Ben Franklin Retail Store*, 210 B.R. 315 (Bankr. N.D. Ill. 1997). *But see In re Debbie Reynolds Hotel & Casino, Inc.*, 255 F.3d 1061 (9th Cir. 2001) (surcharge proceeds paid directly to person providing benefit as an assessment against collateral, with the surcharge proceeds deriving directly from collateral rather than from estate).

[16] *See, e.g.*, 5-89 COLLIER BANKRUPTCY PRACTICE GUIDE P 89.93 (quoting District of Delaware letter regarding first day DIP financing orders).

2. In a survey of 55 large bankruptcies over the past few years, budgets ranged from $50,000-$275,000, with the exception of a $500,000 budget in the *Energy Future Holdings* case.

3. Because a secured claim on property is senior in priority to an administrative claim (at least in a liquidation),[17] consent is typically required to pay out administrative claims out of cash collateral. Professional fees for the UCC that are given administrative priority should, therefore also require secured lender consent.

a) Many courts have refused to require secured lenders to pay UCC fees out of their own collateral nonconsensually in the event there is not sufficient unencumbered property to pay administrative expenses such as UCC fees, unless such fees qualify to be surcharged against collateral pursuant to section 506(c).[18]

b) In practice, however, some courts have pointed out that absent administrative insolvency and conversion to a chapter 7 liquidation, such administrative claims must be paid to confirm a chapter 11 plan of reorganization, pursuant to section 1129(a)(9)(a). If there are no unencumbered assets from which to pay the administrative claims, the court could require (and some courts have required) that such claims be paid out of secured creditor collateral as a condition to confirmation. Query whether this approach effectively renders the requirement for consent meaningless because, though technically a secured lender could

[17] *See In re Flagstaff Foodservice Corp.*, 739 F.2d 73, 76 (2d Cir. 1984).

[18] *See, e.g.*, *Matter of S & S Indus., Inc.*, 30 B.R. 395, 399 (Bankr. E.D. Mich. 1983) ("[I]t does not follow that in the event the estate has no unencumbered funds from which to pay [professional fees and expenses], the secured creditor becomes obligated to satisfy these obligations. A secured creditor, unless he consents, cannot be compelled to finance a chapter 11 proceeding except to the limited extent provided for in section 506(c).").

withhold consent and cause administrative insolvency/liquidation, the secured creditor is effectively forced to surrender its collateral.

c) Prepetition lenders providing defensive DIP financings may attempt to provide for a "hard cap" on UCC fees in a DIP order, which would provide that the payment of any professional fees and expenses would not be necessarily paid out for confirmation of a plan of reorganization. However, absent UCC consent, courts may be unwilling to accept a "hard cap" arrangement.

4. Fee caps are often one of the most hotly contested provisions in a DIP order.

a) Secured lenders are loathe to pay out of their own collateral for challenges to their own liens, while UCC counsel will insist that an unlimited budget may be necessary for the committee to adequately fulfill its duties to unsecured creditors.

b) One potential compromise with the UCC on fee caps is to stipulate that should an amount prove to be insufficient, secured lenders would stipulate that they would support the court's reconsideration of the amount in the carve-out should the facts and circumstances require a higher budget.

E. Avoidance Action Proceeds

1. Since developments in the case law holding that avoidance actions (i.e. causes of action stemming from Article 5 of the Bankruptcy Code) are not property of the estate but simply a right held for the benefit of

creditors,[19] DIP lenders now typically seek to provide liens on avoidance action *proceeds*.

2. UCCs may emphasize cases that explain that avoidance action proceeds are for the benefit of unsecured creditors (not mentioning, of course, that the debtor has every right to grant liens on unencumbered property to raise postpetition financing that benefits the estate).

3. The fact that liens and superpriority claims on avoidance action proceeds are very regularly entered in DIP orders is indicative of the strength of this common UCC objection. Liens and superpriority claims on the avoidance actions themselves will be subject to much stronger opposition.

III. Competing DIP Financings

A. <u>Potential Providers of Alternative DIP Financing</u>

1. Junior secured creditors (to the extent not prohibited in the intercreditor agreement)

2. Equity sponsors desiring continued control/influence, especially where there is a strategic relationship, or otherwise saving face on equity investment

3. Standalone, "pure" DIP financing by new lenders

   a) Traditional banks

   b) Direct lending investment funds

4. Unsecured creditors (occasionally offered, but usually appears more of a litigation tactic; rarely, if ever, consummated in large cases)

[19] *In re Cybergenics Corp.*, 226 F.3d 237, 244 (3d Cir. 2000); *see also In re G-I Holdings Inc.*, 313 B.R. 612, 632 (Bankr. D.N.J. 2004).

B. Rationale for Competing DIP Financing

1. Unencumbered Assets: Competing DIP lenders may argue that there are significant unencumbered assets on which a new DIP provider could lend.

2. Necessity/Size: Competing DIPs may emphasize that the debtor does not need as large a DIP (UCCs often argue that DIP financing is not necessary at all).

3. Terms: Competing DIPs will match or attempt to beat a defensive DIP on key economic terms.

C. How Defensive DIP Lenders Respond to Alternative DIP Proposals

1. Standard of Review: Courts defer to a debtor's business judgment "so long as a request for financing does not 'leverage the bankruptcy process' and unfairly cede control of the reorganization to one party in interest"[20]

2. Strategies

a) Presentation of evidence, including testimony of professionals, can show that alternatives are illusory or unattractive. Professionals and management may testify as to necessity of a DIP and whether DIP is truly committed and/or truly junior to prepetition secured lenders offering a competing, defensive DIP financing. This evidence will support the business judgment of the debtor in selecting the defensive DIP. Many

[20] *In re Barbara K. Enters., Inc.*, No. 08-11474, 2008 WL 2439649, at *14 (Bankr. S.D.N.Y. June 16, 2008); *see also In re Ames Dep't Stores, Inc*., 115 B.R. 34, 40 (Bankr. S.D.N.Y. 1990) ("[C]ases consistently reflect that the court's discretion under section 364 [of the Bankruptcy Code] is to be utilized on grounds that permit [a debtor's] reasonable business judgment to be exercised so long as the financing agreement does not contain terms that leverage the bankruptcy process and powers or its purpose is not so much to benefit the estate as it is to benefit a party-in-interest.").

competing DIPs are offered for the sole purpose of leverage in negotiations or as support for an otherwise standalone objection to a DIP.

b) Alternative DIP providers may require upfront fees or other inducements that prepetition secured lenders are not required to permit to the extent they require access to cash collateral.