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Plan Conversions of Debt to Equity: The Means, the Math, the Risks and the Upsides

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PLAN CONVERSIONS OF DEBT TO EQUITY

General Observations

In a debt-for-equity swap under a reorganization plan, certain creditors of the debtor (typically, bondholders or lenders) agree to cancel some or all of the debt in exchange for equity in the reorganized company. The exchange becomes the lynchpin of the company's plan, which may be a prepackaged or prearranged plan (often the case), or a plan formulated after the bankruptcy filing, and which at times leaves other classes of creditors entirely or substantially unimpaired. Frequently, debt-for-equity deals occur when large companies run into severe financial trouble, with these companies being taken over by their principal creditors. This mechanism preserves the going concern value of the debtor, avoiding the need for the sale of the business or its assets at a depressed price. As a consequence of the swap, the stake in the company of the original shareholders (who will usually be "out of the money" anyway) is significantly diluted, if not completely eliminated, in these deals in the chapter 11 bankruptcy. The debtor's management often retains their respective positions and a minority equity stake. Typically, the reorganization becomes, in essence, self-funded – thereby avoiding the need to seek outside refinancing of existing debt, which may be difficult and unduly expensive, if not impossible, in some cases.

A debt-for-equity swap is especially appropriate where a company is having solvency issues but is still ultimately viable. Through the debt-for-equity swap, the removal of substantial debt from a company's balance sheet will improve its financial profile, facilitating obtaining credit from suppliers and vendors, as well as improving liquidity and relieving pressure on future business operations (given the relief from substantial debt service obligations). Not only does this make confirmation of the plan more feasible, but the reorganized debtor is more likely to survive in an environment of any subsequent lower levels of business activity. A debt-for-equity swap may also improve a company's prospects of obtaining new financing in the future if the need arises. A deleveraged balance sheet will be attractive to potential future lenders. Further, if the company's lender or key investor has been persuaded to demonstrate its longer commitment (by taking equity in the reorganized company,) it may be willing to commit more financing to better ensure the company's continuing viability and maximizing any upside potential it stands to gain as an equity holder. Moreover, implementing a debt-for-equity strategy in the chapter 11 context provides other important benefits such as the discharge of other unwanted obligations and the flexibility of restructuring payments to holders of priority tax claims and other secured claims generally not available outside of bankruptcy.

If the eligible creditor does not make the swap, the debtor may be forced to liquidate and the creditor in turn may get pennies on the dollar for its debt. If however the company's debt is reduced, the failing business can potentially pull itself up and the value of the creditor's new equity can grow, redounding to the benefit of the participating creditor. The swap though is based on the unavoidable risk - that the reorganized business will be successful. In the event that the business cannot become solvent or that a reorganization is impractical (and ultimately results in a later liquidation), the creditor would lose its investment. Certainly, a debt-for-equity creditor should hesitate in seeking or participating in a debt-for-equity swap when it cannot forecast improving business conditions or an appreciation in the value of the reorganized debtor.

With particular respect to secured lenders, if the lender is fully or substantially secured by liens on the debtor's assets, the lender may have little incentive to support the debtor in a debt-for-equity plan, since this will entail a loss of the lender's priority on any subsequent liquidation of the debtor (shareholders rank behind creditors for recovering monies in a liquidation). Consequently, the main justification for a secured lender to swap debt for equity will be a strong belief that, if they take equity, this will ultimately achieve a greater return as the debtor (hopefully) improves its financial condition. Further, while debt-for-equity swaps have worked well for secured creditors and bondholders, the strategy has not often been used by run-of-the-mill unsecured creditors. Unlike those creditors or classes of creditors that enjoy crucial positions higher up on the balance sheet, such classes of general unsecured creditors are often too fragmented to organize an effective, focused reorganization effort.

In addition to the foregoing considerations, for the creditor exchanging debt for equity, the strategy offers a streamlined process for acquiring the debtor's business and eliminating the risks and uncertainties of a § 363 sale or out-of-court remedies. Indeed, with the rising prevalence of private equity funds and other strategic distressed debt investors in bankruptcy cases, the debt-for-equity scenario may be used as a takeover mechanism by an outsider. An outside investor can aggregate a control position by acquiring debt claims, anticipating that such claims may be converted to a controlling interest of the equity of the reorganized debtor, and may be able to better influence the chapter 11 case and plan negotiations.

As noted above, the debt-for-equity strategy is often implemented through a pre-packaged or pre-negotiated bankruptcy case. Negotiations with pivotal creditors or classes of creditors (either directly or through *ad hoc* committees), facilitated by forbearance from enforcement of creditor remedies during such negotiations, can progress without the immediate need for a defensive bankruptcy filing. This has the obvious advantage of avoiding the costs, uncertainties, risks and loss of value to the underlying business that may follow from a freefall bankruptcy case. The ability to effectuate a speedy and cost-efficient bankruptcy case is frequently an essential factor in preserving going concern value for the benefit of creditor classes. However, uncooperative creditors and shareholders may be able to mire carefully planned pre-negotiated bankruptcy cases in costly and protracted litigation, thereby delaying the restructuring of the underlying business and forcing a contested confirmation which may entail, among other things, complex and expensive valuation proceedings.

Rights Offerings / Backstop Agreements

A related mechanism in the chapter 11 plan context is a rights offering. Under a rights offering in connection with a reorganization plan, certain stakeholders (often, qualified unsecured creditors, and less frequently, existing shareholders) are offered the "right" on a pro rata basis to contribute new money in exchange for shares of the reorganized debtor – frequently at a discount.[1] Commonly, the rights offering is open for a period up to about 30 days, if not

[1] Some recent rights offering cases include In re Bonanza Creek Energy, Inc., Case No. 17-10015 (KJC) (Bankr. D. Del. April 7, 2017) (prepackaged plan confirmed, docket no. 502); In re Peabody Energy Corp., Case No. 16-42529-399 (Bankr. E.D. Mo. March 17, 2017) (plan confirmed, docket no. 2763); In re CHC Group Ltd., Case No. 16-31854 (Bankr. N.D. Tex. March 3, 2017) (plan confirmed, docket no. 1794); In re MPM Silicones, LLC, No. 14-22503 (RDD) (Bankr. S.D.N.Y. Sept. 11, 2014) (plan confirmed, docket no. 1001).

shorter. Subject to certain conditions under nonbankruptcy law, the debtor-issuer is not required to obtain shareholder approval of the rights offering.

The use of rights offerings in chapter 11 cases stems from the flexibility provided through section 1145 of the Bankruptcy Code. Subject to certain conditions being met, section 1145(a)(1) exempts some rights offerings from SEC registration requirements, providing more certainty and incentive for investors to purchase new securities in the bankruptcy case. The section 1145 exemption provides prepetition creditors and equity holders, free from the burdens of complying with securities laws, with incentive to invest in the reorganized company. Further, at times, debt-for-equity swaps are proposed in prepackaged chapter 11 plans, and the Bankruptcy Code exempts such plans from certain solicitation requirements, while provisions of the Securities Act may exempt the prepetition solicitation of votes from registration and disclosure requirements of the Securities Act and Blue Sky Laws.[2]

Although many rights offerings are oversubscribed in practice, in order to ensure that a debtor's capital requirements are satisfied, and the chapter 11 plan is feasible, rights offerings usually include a backstop agreement through which a party or parties supporting the plan agree(s) to purchase any shares not purchased through the offering. Frequently, the backstop party is an *ad hoc* group of bondholders and other institutional holders that receive nonpublic financial information and are willing to underwrite the offering. Based on the risks to the backstop parties, such parties typically require substantial fees, often calculated as a percentage of the total offering. Arguably excessive backstop fees and inappropriate inside preference for the backstop party to acquire a control position in the reorganized company for arguably less than fair value may become issues in a rights offering case.

Liquidity of the reorganized company shares often is a key objective of the plan sponsors, which may lead to restrictions on those creditors who may participate in the offering. To achieve maximum liquidity for themselves, plan sponsors often structure deals in a manner that limits participation to "qualified institutional buyers" under Rule 144A, effectively excluding smaller creditors, or to those who qualify under Rule 144. These limitations in turn sometimes generate objections under section 1123(a)(4) of the Bankruptcy Code (requiring the same treatment for each member of a class). See, e.g., In re Washington Mutual, Inc., 442 B.R. 314, 360-61 (Bankr. D. Del. 2011) (holding that plan must be modified to allow all "PIER Claimants" including those with smaller claims the opportunity to participate in the rights offering). Often, the plans provide that trade and small creditors are separately classified, and cashed out with the new money raised by the rights offering, at times at a discount to the face amount of their claims.

From one perspective, a rights offering may be viewed as a sale of the debtor, without the risks of competition, overbids and other requirements imposed by Bankruptcy Code section 363. In many cases, as noted, the offering –typically with a discount– is oversubscribed, especially given the increasing presence and participation of strategic secondary debt purchasers.

[2] The securities law aspects of rights offerings are complex. Depending on whether the recipient of the right is simply an unsecured creditor receiving the right in consideration of its claim, a backstop party receiving it as underwriting compensation (see further herein), or an institution that meets certain size and sophistication tests, different protocols will govern whether securities must be registered, and how and when they may be resold.

Valuation Disputes

Not surprisingly, valuation disputes and issues may arise in debt-for-equity bankruptcy cases, where junior creditors and existing equity holders (as applicable) may try to stop or delay plan confirmation by establishing that too much value is being given to the lenders, bondholders or other senior creditors (as applicable), with little or nothing left for junior creditors and stockholders. At times, a debt-for-equity plan may be strongly supported by nearly every constituency in the chapter 11 case (since the reorganized debtor with a deleveraged, stronger balance sheet continues on with its business), except junior creditors or shareholders that may be out of the money.

An illustrative case is In re Genco Shipping & Trading Ltd., Case No. 14-11108 (SHL) (Bankr. S.D.N.Y. July 2, 2014) (plan confirmed, docket no. 322). There, the debtor (one of the world's largest dry bulk shipping companies) proposed a prepackaged plan seeking to implement a consensual debt conversion restructuring which was supported by the debtor's lenders. The plan framework was to (i) convert \$1.2 billion of debt to equity, (ii) extend maturity dates on certain prepetition secured credit facilities, (iii) give to unsecured noteholders some equity and a right to participate in up to 20% of a rights offering, (iv) provide new liquidity through a backstopped \$100 million rights offering, and (v) provide existing equity holders with warrants (to cover 6% of new equity) in exchange for cancelling their equity interests. In the determination of the reorganized debtor's business enterprise value, the debtor urged the court to adopt a Net Asset Value (NAV) methodology, which posited a value between approximately \$1.36 billion and approximately \$1.44 billion. The equity committee urged a weighted approach heavily weighting the discounted cash flow (DCF) method, as well as also employing the comparable companies method, precedent transactions method, and Assessed Break-Up Value method. Utilizing more traditional valuation methodologies typically used by investment bankers, the equity committee's posited valuation range was between approximately \$1.54 billion and approximately \$1.91 billion. The debtor argued, among other points, that these methods were not how the industry valued itself. In the debtor's view, the NAV method provided an impartial assessment of the broadest, most concrete consensus regarding future earnings. Specifically, the debtor engaged third party appraisers to conduct asset level valuations of the Genco fleet.

The Genco court concluded that the debtor had established by a preponderance of the evidence that its value did not exceed \$1.48 billion. As recognized by the court, there are three main methodologies commonly used to determine reorganization value: (i) DCF analysis, (ii) the market multiple approach, and (iii) the comparable transaction approach; however, according to the court, it has substantial discretion to determine the appropriate method(s) depending on the specific facts of the case. According to the court, in that case, the DCF approach was not appropriate because of the highly speculative nature of rate projections in dry bulk shipping; the comparable companies approach, with adjustments for the nature of the industry, was of some utility; precedent transactions had limited utility because the transactions pool was limited; and the NAV approach (urged by the debtor), while it should not be given sole basis for the valuation, should be given significant weight in light of the dry bulk shipping industry. See Genco Shipping & Trading Ltd., Case No. 14-11108 (SHL) (Bankr. S.D.N.Y. July 2, 2014) (memorandum opinion on confirmation issues, docket no. 321).

Cases like Genco illustrate the extensive, costly and/or litigious valuation disputes that develop at times in debt-to-equity bankruptcy cases, which may require the utilization of myriad appraisal firms, investment bankers, and other experts. Valuation disputes have arisen in other recent cases like In re Bonanza Creek Energy, Inc., Case No. 17-10015 (KJC) (Bankr. D. Del.) (ad hoc equity committee posited $1.6 billion valuation, while debtor's debt-for-equity plan pegged value between $540 million and $730 million; court ultimately found debtors' enterprise value insufficient to support any distribution to shareholders).

Equity Committees

In debt-for-equity bankruptcy cases, while uncommon, it is possible that under the circumstances an official committee of equity holders may be appointed by the U.S. Trustee pursuant to Code section 1102(a)(1). Usually, such appointment will be made upon a request from parties in interest (for example, an ad hoc group of shareholders), since this appointment power is discretionary. If the U.S. Trustee refuses to appoint an equity security holders committee (or alternatively), a party may request the court to order the appointment of such a committee under section 1102(a)(2), if necessary to secure adequate representation of equity holders. See, e.g., In re Wang Lab., Inc., 149 B.R. 1 (Bankr. D.Mass. 1992) (considering existence of approximately 70,000 shareholders (counting beneficial holders), the complexity of the case, and that the debtor was not "hopelessly insolvent," appointment of equity committee was appropriate). If more than one class of equity security holders exists (such as preferred shareholders), more than one equity holders committee may possibly be appointed (although this is a rare occurrence).

Often, at a minimum, equity holders will be required to establish that it appears that some value exists in the bankruptcy case for equity holders. See, e.g., In re Williams Communications Group, Inc., 281 B.R. 216 (Bankr. S.D. N.Y. 2002) (appointment of equity committee should be rare exception; such committee should not be appointed unless there is substantial likelihood that meaningful distribution to equity holders may be made in the case and they are unable to adequately represent their interests without an official committee).

Other Potential Issues

Depending on the debtor's circumstances, a debt-for-equity strategy may have other important consequences. For example, the issuance of new equity through a debt-for-equity plan may trigger defaults under existing but otherwise unimpaired loan contracts or other important agreements (*e.g.*, change-of-control provisions), and cause adverse tax consequences or loss or reduction of valuable tax attributes (such as net operating loss carry-forwards (NOLs)).

In particular, although a debt-for-equity swap in bankruptcy should not technically result in cancellation of indebtedness income to the distressed business, it will very possibly result in the reduction of the company's tax attributes such as NOLs. The swap also will likely be deemed an ownership change for federal income tax purposes potentially further limiting the ability to utilize NOLs and other tax attributes. The Internal Revenue Code includes provisions that address debt-for-equity swaps implemented in bankruptcy court that may favorably alter these results.

Finally, potential funding difficulties may affect the debt-for-equity strategy. There may be insufficient financing available to fund either or both of (i) the debtor's operations pending consummation of the swap (especially if the chapter 11 case is delayed by uncooperative creditors and stockholders raising valuation and other plan confirmation issues, as noted above) and (ii) the reorganized debtor's emergence from bankruptcy (although as discussed above, backstop arrangements may ameliorate this risk). As generally with any other bankruptcy reorganization, a bankruptcy reorganization predicated on a debt-for-equity swap requires sufficient funding -- through operations, DIP financing, and/or funding by the creditors whose debt will be converted into equity.