



AMERICAN
BANKRUPTCY
INSTITUTE

2017 Delaware Views from the Bench

Experienced Practitioners Track **Trends in Secured Financing, DIP Lending, Cash Collateral and Exit Financing**

Robert J. Dehney, Moderator

Morris, Nichols, Arsht & Tunnell LLP; Wilmington

Hon. Kevin J. Carey

U.S. Bankruptcy Court (D. Del.); Wilmington

Matthew Barr

Weil, Gotshal & Manges LLP; New York

Dimitri G. Karcazes

Goldberg Kohn Ltd.; Chicago



Delaware Views from the Bench 2017

Trends in Secured Financing, DIP Lending, Cash Collateral
and Exit Financing



Panelists

- The Honorable Kevin J. Carey
 - United States Bankruptcy Court for the District of Delaware
- Matt Barr
 - Weil, Gotshal & Manges LLP
- Dimitri G. Karcazes
 - Goldberg Kohn Ltd.

Moderator:

- Robert J. Dehney
 - Morris, Nichols, Arsht & Tunnell LLP

Topics

- Secured Financing
 - Unrestricted Subsidiaries
 - “Ticking” Restructuring Fees
- DIP Financing and Cash Collateral
 - Impact of FILOs, AALs and ICAs on Roll-ups
 - Heightened Scrutiny or Entire Fairness for Insider DIP Loans
 - Junior DIP Financing
 - *In re Molycorp*, 1129(a)(9)(a), and Committee Investigation Fees
 - Case Milestones
- Exit Financing
 - Rights Offerings and Equal Treatment Under 1123(a)(4)

3

Secured Financing

- Unrestricted Subsidiaries
- “Ticking” Restructuring Fees

4

Secured Financing – Unrestricted Subsidiaries



MORRIS
NICHOLS
ARSHT &
TUNNELL

- Covenants in a financing agreement generally apply to the company and its “restricted” subsidiaries
- Unrestricted subsidiaries are not bound by financing agreement covenants that apply to the restricted group
- Uses / Benefits:
 - Transfer assets outside of the purview of the financing agreement’s restrictive covenants
 - Once assets are in the hands of the unrestricted subsidiary, can then be used as security for new financing
 - Incur additional debt on a standalone basis
 - Sell assets, pay dividends, and make investments that would be restricted in the hands of the borrower or restricted subsidiaries

5

Secured Financing – Unrestricted Subsidiaries



MORRIS
NICHOLS
ARSHT &
TUNNELL

- Challenges:
 - Transactions between the restricted group and the unrestricted subsidiary may be subject to a “transactions with affiliates” covenant
 - Lose benefits available to companies within the restricted group (e.g., unlimited transfers, intra-group loans, and capital contributions)
 - Potential tax implications
 - Unrestricted subsidiary’s income is not included in the EBITDA of the parent company
 - May require the unrestricted group to prepare separate quarterly and annual financial statements

6

Secured Financing – Unrestricted Subsidiaries



- Legal Issues:
 - Contract interpretation
 - Potential fraudulent transfer implications
- Examples:
 - J. Crew
 - iHeartMedia
 - David's Bridal
 - Neiman Marcus

7

Secured Financing – “Ticking” Restructuring Fees



- Fee earned in connection with prepetition credit agreements and amendments becomes due if the company fails to pay prepetition obligations by date certain
- Lender typically negotiates fee in connection with a prepetition forbearance or amend and extend agreement
- If borrower does not repay or refinance by date certain, fee becomes payable
- In borrower's bankruptcy, the lender agrees to waive the fee or extend the payment date in connection with providing a DIP loan

8

Secured Financing – “Ticking” Restructuring Fees

- Case Example – *In re Nuverra Environmental Solutions, Inc.*, Case No. 17-10949 (Bankr. D. Del.)
 - DIP loan involving a roll-up of the prepetition revolving credit facility
 - As part of the roll-up, the lenders agreed to waive a \$5 million “Restructuring Fee” in the prepetition financing agreement, if a “Closing Fee” of \$1 million was approved, and either:
 - the final DIP order became final and the roll up payments were not reversed;
 - all other prepetition obligations to the lenders (\$30M) were allowed in the final DIP order; or
 - The prepetition and DIP obligations are paid in full prior to the effective date of the plan and a date certain
 - The Committee objected. The parties settled before hearing, but the overall structure (reduction of fee in return for certainty/timing re roll-up and repayment) was preserved

9

DIP Financing and Cash Collateral

- Impact of FILOs, AALs and ICAs on Roll-ups
- Heightened Scrutiny or Entire Fairness for Insider DIP Loans
- Junior DIP Financing
- *In re MolyCorp*, 1129(a)(9)(a), and Committee Investigation Fees
- Case Milestones

10

DIP Financing – Impact of FILOs, AALs, ICAs on Roll-Ups

MORRIS
NICHOLS
ARSHT &
TUNNELL

- FILO – “First-In Last-Out”
 - Junior loan that is part of a larger revolving lending transaction and secured by a common lien whereby the lender advances the total amount of the loan to the borrower (“first-in”)
 - The loan is “last-out” in the sense that the other loans secured by the same lien are repaid first
 - Similar to a term loan, FILO loan funds cannot be reborrowed after repayment

11

DIP Financing – Impact of FILOs, AALs, ICAs on Roll-Ups

MORRIS
NICHOLS
ARSHT &
TUNNELL

- AAL – Agreement Among Lenders
 - Agreement between lenders that are parties to the same credit facility with one agent holding the lien on collateral securing all of the obligations owing to the lenders
 - Establishes the relationship between “first out” and “last out” lenders or splits collateral among the lenders
- ICA – Intercreditor Agreement
 - Agreement between two creditors holding separate liens against the same assets that secure obligations of the same debtor owing under separate credit facilities
 - ICA alters the rights each lender has as separate secured lenders

12

DIP Financing – Impact of FILOs, AALs, ICAs on Roll-Ups



MORRIS
NICHOLS
ARSHT &
TUNNELL

- Proliferation of second lien financing, split-lien financing and unitranche financing has led to the increased use of AALs and ICAs, and their interpretation in bankruptcy
- Questions as to whether prepetition capital structures can be rolled up into a DIP facility with less than full participation or consent from existing lenders
- Even where roll up is possible, the participation rights of lenders within the prepetition structure is complicated by the layers

13

DIP Financing – Entire Fairness or Heightened Scrutiny for Insider DIP Loans



MORRIS
NICHOLS
ARSHT &
TUNNELL

- If an “insider” of the debtor benefits from the DIP loan (especially a controlling insider), a court may apply:
 - Entire Fairness; or
 - Heightened Scrutiny
- Issue in portfolio company bankruptcies where board is controlled by equity sponsor and equity sponsor is offering DIP
- Enhanced scrutiny and heightened scrutiny may be avoided with sufficiently empowered independents

14

DIP Financing – Entire Fairness

- Entire Fairness
 - Most exacting 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; and
 - Fair dealing
- Applied when the party opposing the DIP can show:
 - The directors did not in fact make a decision;
 - The directors' decision was uninformed;
 - A majority of the directors were not disinterested or independent;
 - The directors were grossly negligent; or
 - The transaction is with a controlling shareholder.
- Case examples:
 - *In re Los Angeles Dodgers LLC*, 457 B.R. 308 (Bankr. D. Del. 2011)
 - *In re UCI International, LLC*, Case No. 16-11354 (Bankr. D. Del.)

15

DIP Financing – Heightened Scrutiny

- Heightened Scrutiny
 - Intermediate standard applied by some bankruptcy courts
 - Between business judgment and entire fairness
 - Does not appear to have a counterpart in the non-bankruptcy 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 insider influence, but cannot show that an insider controlled the transaction
- Case example:
 - *In re TerreStar Networks Inc.*, Case No. 10-15446 (Bankr. S.D.N.Y.)

16

DIP Financing – Avoiding Entire Fairness or Heightened Scrutiny

MORRIS
NICHOLS
ARSHT &
TUNNELL

- 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 entire fairness and heightened scrutiny:
 - Appointing an independent director and giving that director authority to make decisions and approve actions;
 - Obtaining approval of a majority of non-insider shareholders/stakeholders;
 - 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

17

Junior DIP Financing

MORRIS
NICHOLS
ARSHT &
TUNNELL

- Generally structured as a FILO loan
- The debtor does not repay the junior loans until the senior DIP is paid in full
- Inter-creditor agreements often prohibit junior secured creditors offering DIP financing without the consent of senior secured creditors
- Junior DIP financing has become more popular
 - *In re Boomerang Tube Inc.*, Case No. 15-11247 (Bankr. D. Del.)
 - *In re Simplexity LLC*, Case No. 14-10569 (Bankr. D. Del.)
 - *In re Loehmann's Holdings*, Case No. 13-14050 (S.D.N.Y.)
 - *In re Borders Group, Inc.*, Case No. 11-10614 (Bankr. S.D.N.Y.)

18

Junior DIP Financing

- Benefits of Junior DIP Financing
 - May enhance value for senior lenders while preserving value and optionality for junior lender – allows junior lender to bid time
 - May be necessary when the senior DIP lender is unwilling or unable to extend new credit
 - The debtor has often immediate access to the entire junior line of credit because of FILO structure of many junior DIP loans

19

DIP Financing – *MolyCorp*, Section 1129(a)(9)(A), and Committee Fees

- Section 1129(a)(9)(A) requires that, unless otherwise agreed, each administrative claimant must receive cash equal to the allowed amount of its claim on the effective date of the plan
- Includes allowed professional fees of official committees incurred in investigating DIP lenders' liens and claims

20

DIP Financing – *Molycorp*, Section 1129(a)(9)(A), and Committee Fees

The logo for Morris Nichols Arsht & Tunnell, a law firm, is displayed in white text on a dark red square background.

- *In re Molycorp, Inc.*, 562 B.R. 67 (Bankr. D. Del. 2017)
 - Carve-out provision in a DIP financing order did not constitute a limit on the fees and expenses payable to professionals retained by a creditor's committee
 - Court overruled objections by the DIP lender, who argued that a negotiated carve-out in the DIP order should serve as a cap on the Committee professionals' compensation
 - Central to the Court's holding was that the Debtors had confirmed a plan of reorganization and thus, section 1129(a)(9)(A) applied
 - The Court held that administrative claims must be paid in full even if it means invading secured lenders' collateral

21

DIP Financing – *Molycorp*, Section 1129(a)(9)(A), and Committee Fees

The logo for Morris Nichols Arsht & Tunnell, a law firm, is displayed in white text on a dark red square background.

- Takeaways:
 - 1129(a)(9)(A) trumps a traditional DIP carve-out
 - Court left unanswered whether language could be included in the DIP order providing for an “automatic and absolute cap on the allowance of administrative claims”
 - For example, DIP lender may insist on language in DIP order providing that fees in excess of investigation budget shall not be allowed administrative expenses and/or language providing that fees in excess of investigation budget shall be automatically disallowed

22

DIP Financing – Milestones

- “Milestone” covenants often require the debtor to make progress toward a reorganization or sale
- Failure to meet a milestone may permit the lender to cease providing funding, terminate the stay, and/or foreclose
- Typical milestones include:
 - Filing a bid procedures motion
 - Filing a sale motion
 - Conducting an auction
 - Closing a sale
 - Filing a plan
 - Confirming a plan

 23

DIP Financing – Milestones

- DIP milestones continue to be popular and are regularly approved
- Proposals for aggressive milestones often draw objections from the creditors’ committee and other parties in interest
 - Objections generally assert that the milestones do not permit the time to conduct an adequate and fair sale process or sufficient time for the debtor to confirm a plan of reorganization
 - Examples:
 - *In re Delivery Agent, Inc.*, Case No. 16-12051 (Bankr. D. Del.)(the Committee objected to aggressive milestones)
 - *In re Maxus Energy Corporation*, Case No. 16-11501 (Bankr. D. Del.)(a party in interest objected to aggressive milestones)

 24

Exit Financing

- 1123(a)(4) and Rights Offerings

25

Exit Financing – 1123(a)(4) and Rights Offerings

- Rights offerings
 - Debtor issues a specific class (or classes) rights to purchase the reorganized debtor's equity at a price normally below market price
 - Typically backstopped by investors agreeing to purchase unpurchased shares
 - An effective tool for a debtor to obtain exit financing or other capital
- Section 1123(a)(4)
 - Requires a plan to provide the same treatment for each claim or interest of a particular class on account of such claim or interest, unless the holder of a particular claim or interest agrees otherwise

26

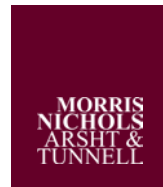
Exit Financing – 1123(a)(4) and Rights Offerings



- Common objection to rights offerings is that they unfairly discriminate against creditors who are not offered the ability to participate in the offering
- Typically, the creditors contend that they are similarly situated creditors, despite how they are classified in the plan or the size of their claims, and should be entitled to participate

27

Exit Financing – 1123(a)(4) and Rights Offerings



- *In re Washington Mutual, Inc.*, 442 B.R. 314 (Bankr. D. Del. 2011)
 - Bankruptcy Court sustained an 1123(a)(4) objection regarding a rights offering
 - Plan included a \$100 million rights offering to a class of claimants but excluded creditors who held less than \$2 million in claims in that class
 - Individual creditor objected, arguing he was being discriminated against in violation of 1123(a)(4)
 - The debtor argued that
 - the threshold was necessary for administrative convenience as the plan was distributing \$7.5 billion in assets; and
 - not discriminatory treatment because the rights offering is of no value

28

Exit Financing – 1123(a)(4) and Rights Offerings



MORRIS
NICHOLS
ARSHT &
TUNNELL

- *In re Washington Mutual* (cont.)
 - The Court held:
 - administrative convenience is not a permissible work-around of 1123(a)(4); and
 - rights offering had value – the right to buy into a company has inherent value due to the upside if company is successful
 - The Court held that the debtor must modify the rights offering to include all claimants in the class

29

Exit Financing – 1123(a)(4) and Rights Offerings



MORRIS
NICHOLS
ARSHT &
TUNNELL

- *In re Peabody Energy Corp.*, Case No. 16-42529 (Bankr. E.D. Mo.)
 - Peabody recently emerged from bankruptcy after \$750 million rights offering and \$750 million private placement
 - The rights offering allowed creditors in certain classes to purchase common stock of the debtors at a discount
 - The private placement was a sale of preferred stock to certain noteholders who agreed to support the plan
 - The preferred stock provided for an 8.5% dividend and a right to convert it to common stock at a 35% discount
 - The ad hoc committee of non-consenting creditors objected to the private placement
 - Asserted that the private placement violated 1123(a)(4) because it discriminated against similarly situated creditors

30

Exit Financing – 1123(a)(4) and Rights Offerings

MORRIS
NICHOLS
ARSHT &
TUNNELL

- *In re Peabody Energy Corp* (cont.)
 - Court overruled the objection, finding that creditors do not have a right to participate in the private placement
 - The right to participate was not on account of a claim
 - It was an investment, not a treatment under the plan
 - Language was included in the order providing that both the rights offering and private placement were made not on account of the participating creditors' claims
 - Issue currently on appeal.

31

Question and Answer

MORRIS
NICHOLS
ARSHT &
TUNNELL

- Questions?

32

**MORRIS
NICHOLS
ARSHT &
TUNNELL**

mnat.com   (302) 658-9200

1201 North Market Street, 16th Floor
P.O. Box 1347
Wilmington, DE 19899-1347

These materials have been prepared solely for informational and educational purposes, do not create an attorney-client relationship with the author(s) or Morris, Nichols, Arsht & Tunnell LLP, and should not be used as a substitute for legal counseling in specific situations. These materials reflect only the personal views of the author(s) and are not necessarily the views of Morris, Nichols, Arsht & Tunnell LLP or its clients.

Copyright © Morris, Nichols, Arsht & Tunnell LLP. All Rights Reserved.