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Exit Financing in Chapter 11 Bankruptcy: Debt, Equity and Combination Structures

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Exit Financing in Chapter 11 Bankruptcy: Debt, Equity and Combination Structures

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What is exit financing?

- Exit financing enables a chapter 11 debtor to emerge from bankruptcy through its chapter 11 plan of reorganization.
- Provides liquidity to a debtor to make the required payments under its chapter 11 plan.
- Also provides the debtor with the liquidity needed to finance its operations post-confirmation.

What is exit financing?

- In its most basic form, exit financing is a secured or unsecured loan extended by a lender.
- As bankruptcies have evolved, exit financing structures have become more complex.
- While loans remain the most common form of exit financing, other forms of financing now include the issuance of high-yield debt or the issuance of stock in the reorganized debtor.

Uses for Exit Financing

- Exit financing is often used to make the required payments under the chapter 11 plan.
- This can include the payoff of a DIP financing loan, and the payment of other administrative claims, secured claims, priority claims, and general unsecured claims.
- Exit financing can also be used to fund the reorganized debtor's operations going forward, including working capital and capital expenditures.

Goals of Exit Financing

- The debtor and lender should insure that the exit facility is appropriate in light of the debt capacity and needs of the reorganized entity.

- Otherwise, a repeat bankruptcy filing could occur ("Chapter 22").

Types of Exit Financing

- Secured or unsecured loans
  - Can be revolving or term loans, or both
- High-yield debt issuance
- Issuance of equity
- Combinations of the above

Secured and Unsecured Loans

- The terms and conditions of an exit financing facility are similar to a traditional credit facility outside of bankruptcy.
- These can include revolving or term loans, with customary features such as repayment terms, representations and warranties, and covenants.
- Term loans can be used for specific purposes, such as funding payments under the chapter 11 plan or capital expenditures which the debtor may have deferred due to its insolvency.
- Revolving loans, as in a non-bankruptcy setting, are typically used to fund the reorganized debtor's working capital needs.

Secured and Unsecured Loans

- Often, a pre-confirmation DIP financing facility rolls over into a post-confirmation exit financing facility.
- This feature is often negotiated at the time the debtor negotiates its DIP financing facility.
- The same lender or lenders who provided the DIP financing will commit to an exit facility at that time.
- This can be accomplished through the conversion of the DIP facility directly into an exit facility.
- However, it is more common to have a payoff of the DIP facility coupled with the entry into a new loan.

Secured and Unsecured Loan Example

- In re AMR Corporation d/b/a American Airlines:
  - In 2011, AMR and its affiliates filed chapter 11 proceedings in the SDNY.
  - AMR used the bankruptcy to address numerous issues, but also to lay the groundwork for its merger with US Airways.
  - DIP financing included a DIP-to-exit feature.
  - The DIP facility provided that once American emerged from bankruptcy and completed the proposed merger with US Airways, the DIP loan would convert to a standard six-year senior secured term loan.
  - A $1 billion five-year revolving credit facility was also provided to American after the exit from bankruptcy.

High-Yield Exit Financing

- As a result of the 2008 financial crisis, and the retreat of traditional financing sources from the market, it became more common for larger debtors to go to the high-yield markets for all or part of their exit financing.
- Following the crisis, traditional exit financing was difficult for some debtors to obtain under tightened lending standards.
- Issuances of high-yield debt (also referred to as non-investment-grade debt, speculative-grade debt, or "junk" bonds) increased in exit financing, a trend likely to continue because of the attractive terms available in that market.

High-Yield Exit Financing

- In addition, the prevailing low interest rates for traditional commercial loans drove investors to the high-yield markets, where there is a higher rate of return.
- This search for yield led investors to extend credit, in the form of high-yield debt, to a reorganized debtor.
- These drivers of supply and demand are the primary reasons for the increase in high-yield exit financing.

Benefits of High-Yield Exit Financing

- For borrowers, the financing is longer in term than that usually provided by traditional lenders and it is often free of maintenance covenants that subject the borrower to periodic financial tests.
- For lenders, the financing has call protection to protect the upside of the investment and can have a first or second priority lien to protect the downside.
- Call protection generally prohibits a debt issuer from prepaying the debt early on in the life of the issue.
- The financing can either be fully committed or subject to best efforts.

High-Yield Exit Financing Disadvantages

- The financing will require an escrow that involves complex negotiations and can make the plan of reorganization somewhat inflexible.
- In the long term, the call protection provided to the lenders can make it difficult for the reorganized debtor to refinance if the credit markets become more favorable.
- In addition, the fees and interest related to the length of the escrow period can be high.

Escrow Features of High-Yield Debt

- Outside of bankruptcy, escrows are not typically employed in a high-yield financing. Instead, the investors simply fund on the closing date.
- However, if the issuer is a debtor, then the investors will not release any funds to the debtor until the court approves the financing and the confirmation order is final and non-appealable.
- The reason is that if funding is made directly to the debtor and the court does not confirm the plan, then the investors may not be able to retrieve the funding from the bankruptcy estate.
- A court is more likely to approve a financing arrangement and confirm a plan if the exit financing is already funded.

Mechanics of High-Yield Debt Escrow

- The Chapter 11 debtor establishes a nondebtor escrow issuer, which is a bankruptcy-remote entity that will take the funds into escrow and issue the debt to the investors.
- The debtor should obtain an order from the bankruptcy court regarding this structure before any investors transfer funds to the escrow issuer.
- For the debtor to succeed in marketing the strategy to potential lenders and in appeasing their concerns, the order will typically provide: (1) that the issuer is not a debtor; (2) that the proceeds of the high-yield financing are not included as part of the debtor's bankruptcy estate; and (3) that the escrow entity will not be consolidated with the debtor until the effective date of the plan.
- When the plan goes effective, the escrow issuer typically merges into the reorganized debtor, which will then have access to the funds and assume all of the obligations for the debt.

Escrow Features: Bankruptcy Court Approval

- Numerous approvals from the bankruptcy court are required before the Chapter 11 debtor can establish the escrow issuer and the investors will fund.
- Courts will consider numerous factors in making this determination.

High-Yield Exit Financing Examples

- In 2009, Reader's Digest used the high-yield market to raise $525 million in bankruptcy exit financing, cutting interest expenses by $30 million annually. The interest rate on the issue was 9.5 percent.

- In 2010, LyondellBasel Industries sold $2.25 billion of senior secured notes yielding 8 percent to fund its bankruptcy exit.

Equity Offerings

- In addition to issuing debt, a debtor can raise financing to exit Chapter 11 through the issuance of new equity interests in the reorganized debtor.
- In the typical scenario, all of the stock issued by the Chapter 11 debtor is extinguished when the plan of reorganization goes effective and the new investor receives stock issued by the reorganized debtor.
- One of the primary considerations is whether the debtor receives the investment from an insider or a third party.

Equity Offerings to Insiders – New Value Plans

- Where an insider, such as a current shareholder of the debtor, wants to make a new investment in exchange for equity in the reorganized debtor, then the arrangement must meet the fairly rigid requirements for a new value plan set forth by the Supreme Court in Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership, 526 U.S. 434, 442, 119 S.Ct. 1411 (1999).

- In LaSalle, the Supreme Court held that an equity holder of the debtor could not retain that equity by making a new equity investment and taking stock in the reorganized debtor if the opportunity to invest was given only to the debtor's current equity holders. The Supreme Court reasoned that the exclusive opportunity to invest in the reorganized debtor must be subjected to some type of market test. In practice, this often means that a competing investor should be allowed to propose a competing plan of reorganization.

Equity Offerings to Insiders – New Value Plans

- Since LaSalle, some jurisdictions have adopted a multipart test for determining whether a new value plan passes muster. The test usually provides that the new value must be:
  - In money or money's worth;
  - Necessary to the debtor's reorganization;
  - Reasonably equivalent to the interest retained or received by the equity holder; and
  - Provided "up front."
- New value plans often lead to litigation between the debtor's shareholders and creditors over valuation issues, which can delay a debtor's emergence from bankruptcy.
- On the other hand, a new value plan might provide a reorganized debtor the only means to confirm a plan if debt financing is insufficient or not available.

Rights Offerings to Finance a New Value or Other Type of Plan

- A rights offering is where current stakeholders (shareholders, bondholders, or others) of the debtor are given the opportunity to purchase equity in the reorganized debtor. While rights offerings have been employed for many years, such offerings are experiencing a resurgence thanks in part to the beleaguered credit markets.

- In a rights offering, a class of creditors or equity holders is offered the right to purchase equity in the reorganized debtor at a fixed price. The number and value of the shares that a stakeholder is entitled to purchase is proportionate to its prepetition stake in the debtor.

Benefits, Considerations and Features of Rights Offerings

- A rights offering can encourage plan acceptance by providing stakeholders an opportunity to enhance their recoveries through a new investment, at a discount. A successful offering can also give the court and current and prospective stakeholders of the company optimism that the reorganized company will be successful.
- The debtor's equity holders can use a rights offering to protect their original investment from total elimination while avoiding the thorny legal issues arising under a new value plan.
- Shares in the reorganized debtor are typically sold at a discount from the assumed enterprise value as a means to entice stakeholders to exercise their option and to take advantage of the exemption from securities laws.
- The offering may also provide oversubscription rights, where a stakeholder may purchase more than its pro-rata share if the offering is undersubscribed. The plan can also provide for over-allotment rights where a stakeholder can purchase more than its pro-rata share if the offering is fully subscribed, yet there is still additional demand.

Backstop for Rights Offerings

- Backstop commitments are more common for rights offerings than for debt issuances.
- Typically, a creditworthy group of stakeholders that is interested in obtaining much of the new equity will commit to purchasing all of the reorganized debtor's unsubscribed stock.
- The debtor will pay a commitment fee and will sometimes agree to a breakup fee as well.
- While such fees can be substantial, the commitment can help ensure that the debtor's plan passes the feasibility test.

Exemption from Securities Laws

- Section 1145 of the Bankruptcy Code provides issuers of debt and equity securities in Chapter 11 reorganizations with an exemption from registration.
- Securities received under a plan entirely or principally in exchange for claims against the reorganized debtor will be exempt from the registration requirements of section 5 of the Securities Act and may be resold without registration so long as the recipient of such securities is not determined to be an "underwriter" as that term is defined in section 1145(b) of the Bankruptcy Code.

Exemption from Securities Laws

- Courts have held that the purpose of section 1145 is to "encourage reorganization and to relieve bankrupt entities of the strict requirements of securities law so long as adequate disclosure is made" and that accordingly, the exception for "underwriters" found in section 1145(b) should be limited to "real" underwriters (i.e., those engaged in a distribution of securities to the public) rather than "technical" underwriters. See, e.g., In re Frontier Airlines, Inc., 93 B.R. 1014, 1020 (Bankr. D. Colo. 1988).

Committed vs. “Best Efforts” Financing

- In a committed financing, the arranging or agent lender commits to fund the entire amount of the loan and assumes the syndication risk itself. Such commitments are relatively rare for Chapter 11 exit financing.
- It is more common for the arranging lender to commit to fund less than the entire amount of the facility, if anything at all, and pledge its commercially reasonable “best efforts” to syndicate the remainder of the facility so that it is funded on time.

Committed vs. “Best Efforts” Financing

- If the financing is committed, then the lender assumes the risk that the credit markets will not be favorable for funding the facility on the effective date of the plan; in a best efforts scenario, the debtor assumes that market risk.
- Where a plan is based on nothing but a best efforts pledge to syndicate an exit financing, a court may not even set a confirmation hearing, let alone confirm the plan. Among other things, such a plan would not satisfy the feasibility test because there is no certainty at all that the debtor will be able to fund its commitments under the plan.

Committed vs. "Best Efforts" Financing

- The benefits for the debtor of committed financing are that the debtor has the certainty of financing, thus making its chapter 11 plan more likely to pass the feasibility test, and also that the interest rate is likely to be capped, so that a debtor can lock in a favorable interest rate.
- Committed financing will often carry fees that make it more expensive than a best efforts agreement.
- Even in a committed financing, the commitment will likely contain a market material adverse change clause or material adverse effect clause, or both.

Material Adverse Change Clauses

- Usually, the market material adverse change clause is rooted in the credit markets and allows the lender to avoid its funding commitment if the credit markets are unfavorable on the proposed funding date.
- On the other hand, a material adverse effect clause is linked to the debtor's performance.
- Solutia Inc. v. Citigroup Global Markets Inc., et al., Case No. 08-01057 (Bankr. S.D.N.Y.).

Combination Exit Financing Example – In re BI-LO, LLC et al.

- BI-LO, a grocery retailer, filed its chapter 11 cases in 2009 because it was unable to refinance its credit facility due to the financial crisis.
- As exit financing, BI-LO arranged the following:
  - BI-LO entered into a $200 million new term credit facility, and issued new term notes, which enabled it to fund obligations under the chapter 11 plan.
  - BI-LO also entered into a new revolving credit facility of up to $150 million.
  - BI-LO's prepetition private equity sponsor entered into an equity purchase agreement, pursuant to which the sponsor agreed to invest $150 million in new capital into BI-LO in exchange for new common units of stock.

Combination Exit Financing Example – In re Satelites Mexicanos S.A. de C.V., et al.

- Prepackaged plan in Delaware for a Mexican company that operated several satellites.
- Prepetition debt structure: $238 million in first lien notes, and $202 million in second lien notes
- As exit financing, Satmex arranged obtained bankruptcy court approval for:
  - Issuance of $325 million in high-yield, 9.5 percent bonds
  - Rights offering of $96 million to prepetition second-lien noteholders for equity in reorganized company; rights offering was backstopped by largest holders of prepetition second-lien notes
  - Second-lien holders also had option of converting their debt equity in the reorganized company or accepting 38 cents on the dollar in cash

Thank You

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