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DIP FINANCING IN US CHAPTER 11 CASES: HOW SPONSORS ARE UTILIZING EQUITY CONVERSIONS TO OBTAIN RECOVERIES IN REORGANIZED DEBTORS

In an article first published in the July issue of *Butterworths Journal of International Banking and Financial Law*, the authors examine sponsor-provided debtor-in-possession financing that converts into equity in the reorganized debtor upon emergence from bankruptcy, including the consequences of, and recent challenges to sponsor-led convertible financing.

One of the most heralded features of Chapter 11 of the US Bankruptcy Code is the framework it provides to allow companies that have filed for bankruptcy to obtain needed post-filing financing, referred to as debtor-in-possession or "DIP" financing. Chapter 11 accomplishes this by providing special protections – protections unavailable outside of bankruptcy – that reduce loan risk. Perhaps because such loans are often able to charge higher fees and interest, the result is a competitive marketplace for DIP financing.

A more-recent evolution in the DIP market is the push of pre-petition equity (aka, sponsors) to become DIP lenders who have the right to convert their DIP financing into post-bankruptcy equity. As is common for non-sponsors, that equity would be obtained at a discount and thus provide sponsors with a source of recovery from a failing (or failed) investment. Because of the nature of the DIP loan process, approval of the loan is sought on an accelerated basis – DIP loans are often marketed over a short period pre-bankruptcy and then approved in part on a preliminary "first-day" basis after only a day or two of notice – and could be completed without the benefit of the traditional safeguards of the Chapter 11 plan process or an opportunity for the market to price the value of a company's reorganized equity. Sponsor DIP loans also implicate directors' duties insofar as a company's board members may be conflicted in evaluating financing proposals from the company's equity holders. While sponsor-led DIP proposals have been challenged, the results are inconsistent. Bankruptcy courts grapple with these requests in light of certain underlying Chapter 11 principles. This article examines a number of recent sponsor convertible DIP financing requests and the related court review of the relevant legal issues.

Key points

- Sponsors are seeking to provide DIP loans that include equity conversion features, presumably to boost returns on failed investments
- Because the conversion features often allow sponsors to obtain equity at a discount, perhaps to the detriment of unsecured creditor case recoveries, creditors have objected on various grounds, including that the sponsors are evading the plan confirmation process and violating the absolute priority rule
- A limited number of courts have analyzed equity conversions and, while the decisions are fact specific, the outcomes appear inconsistent
- Recognizing the limited downside to sponsors, it is expected that sponsors will continue to seek to provide DIP loans with equity conversion features in the future

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This article begins with an analysis of Chapter 11 concepts and principles that are important to an examination of a typical sponsor-led convertible DIP financing. The article then turns to an examination of recent case law that has addressed sponsor-led convertible DIP requests, identifying the benefits and risks to sponsors and case creditors related to these financings. Finally, the article provides commentary on whether sponsors are likely to continue to seek such equity conversion rights in light of the mixed case-law on the issues and also explains why US courts are not likely to deliver clear and consistent rulings on these issues in the near future.

CHAPTER 11 PRINCIPLES

Company Oversight. Upon commencement of a case under Chapter 11, a company typically remains "in possession" of its property and business. This means that a debtor's managers continue to run the business during the Chapter 11 case and are able to exercise their judgment in making normal business decisions. Thus, directors continue to be responsible for making oversight decisions consistent with the applicable state law fiduciary duty framework but are now subject to bankruptcy court oversight in certain instances. Importantly, while a company does not need to be insolvent in order to file for bankruptcy, a bankruptcy filing often indicates that the duties of directors have shifted: where directors of a solvent company manage a company for the benefit of shareholders, directors of an insolvent company must manage the company for the benefit of all the company's stakeholders, including creditors and shareholders.

During the course of the bankruptcy and prior to the effectiveness of a plan, a debtor may, subject to court approval, seek to act outside the "ordinary course of business," including by obtaining DIP financing. The reviewing court will typically apply the "business judgment rule" to evaluate the request and, thereafter, authorize the request if it finds that the board reviewed the proposal on an informed basis, in good faith and in the honest belief that the proposed action was in the best interest of the corporation. However, if the directors are not independent or disinterested with respect to the proposed transaction at issue – potentially including where the debtor's equity holders are proposing to provide the debtor with DIP financing – the reviewing court must review the transaction under a stricter "entire fairness" doctrine, meaning that the company must prove that the transaction is entirely fair from the perspective of stakeholders.

Plan Process. The ultimate goal of a Chapter 11 case is to effectuate a plan of reorganization, the plan by which a debtor may implement it reorganization or, in some cases, liquidation. Once approved by the bankruptcy court, a plan is essentially a new agreement between the debtor and its creditors as to how the debts, assets, rights and businesses of the debtor are to be restructured in replacement and discharge of its old contractual relationships. To be approved by a bankruptcy court (aka, "confirmed"), a plan must comply with numerous statutory requirements, have been the subject of a court-approved disclosure statement and solicitation process (this is essentially a prospectus approval process followed by a solicitation process that typically takes about two months), and have been voted upon by each class of creditors entitled to vote. A plan must also provide that dissenting creditors will receive at least as much under the plan as they would receive in a hypothetical liquidation and, absent unanimous consent of all classes

of creditors and equity holders, satisfy the "absolute priority rule"; that is, the plan must pay each class of claimants in full before any junior class of creditors or equity holders may receive or retain anything of value on account of its claims or interests from the debtor.

Because the disclosure and plan approval process are so fundamental to Chapter 11, and more globally to US "due process" rights, courts have not permitted debtors to take actions prior to approval of a plan that effectively dictate the terms of any subsequent plan because, as explained by one circuit court of appeals, the debtor must "scale the hurdles erected in Chapter 11." Courts have referred to such proposals – that is, actions which evade the plan solicitation and voting process – with a somewhat sinister-sounding label, "*sub rosa* plans." That label has recently been applied to certain sponsor-backed DIP conversion proposals, as described further below.

DIP Financing. In many cases, companies in need of liquidity will begin efforts to procure DIP financing prior to commencing a Chapter 11 case so that the terms of a DIP loan can be presented to the bankruptcy court for approval at the "first day" hearing, a hearing often held within a day or two of the bankruptcy filing. DIP loans are often provided by one of several different types of funding providers, including (a) third party lenders, (b) existing secured lenders (perhaps because they are motivated to provide a "protective DIP") or (c) existing equity holders.

Given the importance of DIP funding to many debtors, the Bankruptcy Code incentivizes potential DIP lenders to provide financing in several ways. For example, a court might provide that the DIP loan must be repaid before any other unsecured post-bankruptcy obligations including administrative expenses. Bankruptcy courts may also authorize debtors to obtain DIP financing secured by a lien on unencumbered assets, a junior lien on encumbered assets, or a senior lien (also called a "priming lien") on assets that are already subject to an existing pre-petition lien, provided that the existing secured lenders consent or are "adequately protected" against diminution in the value of their collateral. Another common and often mentioned feature of a DIP loan is the "roll-up". This allows a portion of the DIP loan to be used to pay off the existing pre-petition secured debt on a dollar-for-dollar basis.

Despite these special lender protections, DIP loans are usually priced with high interest rates and substantial fees. DIP loan documents also often contain lender-friendly terms such as favorable covenant packages and extensive reporting requirements. And DIP lenders may obtain substantial control over a Chapter 11 debtor and the course of a Chapter 11 case through consent rights and case milestones.

Another feature of DIP financing is the ability in certain cases to structure the transaction so that, rather than being repaid in cash, DIP obligations are converted into equity in the reorganized company upon its emergence from Chapter 11. As highlighted above, this option has become more commonplace in recent times. Mechanics of an equity conversion typically are heavily negotiated and depend on the circumstances of each individual case.

SPONSOR CONVERTIBLE DIP LOANS

Within the DIP framework examined above, it appears evident that there is an inherent tension between, (i) on the one hand, the desires of a sponsor, who may continue to (at least in theory) control the debtor company through the board of directors but who is likely – pursuant to the absolute priority rule – entitled to no or little recovery from the debtor's bankruptcy case, and (ii) on the other hand, other case creditors, who are likely entitled to all of the value of the debtor's estate. In practice, given the absolute priority rule, state law fiduciary duties, and the various policing mechanisms against "bad" behavior that exist in the Bankruptcy Code, that tension generally favors creditors over equity where the company is insolvent and the plan confirmation process is "in play." However, the balance between the two sides is more difficult to ascertain where a sponsor seeks to provide the DIP loan – which happens very early in the bankruptcy case – and that loan includes an equity conversion feature.

In a number of more-recent sponsor DIP-to-equity conversion cases, interested parties have challenged the debtor's DIP request, often asking whether the sponsor-controlled debtor is truly fulfilling its fiduciary duties when agreeing to the DIP-to-equity conversion. Related thereto, these parties have argued that the conversions dictate future plan terms and evade the protections of the confirmation process, and also that the "value" in providing a DIP is being provided to the sponsor before all other case creditors, potentially in violation of the absolute priority rule. These are difficult questions and the case law is evolving. Some of the leading cases that have addressed these issues are discussed below.

LATAM. In the case of *In re LATAM Airlines Grp. S.A.*, 620 B.R. 722 (Bankr. S.D.N.Y. 2020), the debtors sought approval of what became a two-tranche $2.45 billion DIP loan. The senior tranche consisted of $1.3 billion to be provided by unaffiliated third parties that had no existing relationship to the debtors. The junior tranche consisted of up to $1.15 billion that was to be provided by two of the debtors' largest shareholders, who (along with their affiliates) collectively held over 32% of the debtors' stock. At the debtors' option, the junior tranche would be convertible into equity in the reorganized debtors at a 20% discount to the value ascribed to that equity under a future (*i.e.*, yet to be filed) Chapter 11 plan.

Following a multi-day evidentiary hearing, Bankruptcy Judge James Garrity of the Southern District of New York Bankruptcy Court issued a 142-page opinion that denied the financing request, finding that while certain features of the proposed DIP were reasonable, allowing the debtor's shareholders (not just the DIP lenders) to acquire stock in the reorganized debtor at a discount was a *sub rosa* plan and a violation of the absolute priority rule. According to the court, the shareholders in the case were obtaining conversion rights because they were shareholders and, as such, the debtors were seeking to convert the process from one designed for the benefit of all creditors to one designed to benefit post-bankruptcy lenders. The court also highlighted that the share distribution was not market-tested, the election to distribute equity was without court oversight or approval, and more globally, the election would dictate key terms of a plan of reorganization by prematurely allocating reorganization value to existing equity holders. Ultimately,

the LATAM debtors sought and obtained bankruptcy court approval of the DIP financing without these problematic provisions.

SAS AB. Unlike the debtors in the LATAM bankruptcy, the debtors in the case of *In re SAS AB*, 644 B.R. 267 (Bankr. S.D.N.Y. 2022) were not seeking to grant specific equity conversion rights but instead were seeking to grant equity options. Specifically, a proposed $700 million DIP financing provided by non-insiders included a call option pursuant to which the DIP lenders would have the right to buy $700 million or more of equity at a discount in the future (priced at a methodology set forth in the DIP loan agreement). The DIP also included a tag right pursuant to which the DIP lenders would have the right to purchase 30% of new equity interests issued under a plan on the same terms as those available to a third party. While the applicable agreements provided that these rights could be terminated by the debtors, such termination came at the cost of substantial termination fees.

No objections were raised to the requested DIP terms but Bankruptcy Judge Michael Wiles, also from the Southern District of New York, was still concerned about the equity-related features and thus provided a detailed analysis on the proposed DIP on his own accord. The court itself asked, among other things, how it could permit the sale of tag and call options outside of the plan process as it appeared that the sales might constitute a sub rosa plan. It also asked whether its analysis would be different if the sale was to insiders or to friendly parties. The court highlighted that in future cases it might prove more difficult to determine whether such terms are fair or whether such terms are being used as tools by which insiders, large creditors or friendly buyers to provide themselves unfair advantages in a future plan process. Notwithstanding Judge's Wiles' reservations, because there was no actual "lock" on the purchase of equity and because there were no objections to the proposed financing, he ultimately approved the financing, including the equity options.

Enviva. Enviva is the final case that we examine. It is a more recent case that was litigated during the drafting of this article and seems to provide the most complete example of the disputed issues that (to date) have been associated with sponsor proposed convertible DIP financing. While the decision of the bankruptcy judge described below is being appealed, it is nevertheless an instructive opinion on the issues because, among other reasons, we believe other judges could conclude similarly and the rulings of each bankruptcy judge are not binding on other bankruptcy judges.

On March 12, 2024, wood pellet maker Enviva Inc. and certain of its affiliates filed for bankruptcy in the Eastern District of Virginia. Enviva proposed to obtain a $500 million DIP from its existing lender group. Of note, $100 million of the $500 million facility was allocated to the shareholders, although that allocation was backstopped by the lender group. (As was later explained by counsel to the lender group, the debtors negotiated the shareholder allocation.) There was also an equity conversion of the DIP that the shareholder would benefit from, although details and mechanics related to the equity conversion were subject to a Chapter 11 plan and the terms of a rights offering. As is common, an initial or "interim" order was entered early in the bankruptcy case which permitted the debtors to obtain access to $150 million of the DIP loan.

Thereafter, and before the final hearing on the DIP loan, a creditors' committee was appointed to represent Enviva's unsecured creditors. Among other things, the committee objected to the $100 million "allocation" of the DIP offered to existing shareholders on the ground that a shareholder allocation that included an equity conversion constituted a *sub rosa* plan, violated the absolute priority rule, was not supported by sound business judgment, and was not in the best interest of the debtors' estates.

At the final hearing on the DIP loan, the debtors argued that the shareholder allocation was carefully considered by disinterested directors and should be approved because the unsettled conversion details made the case unlike *LATAM* and because there was clearly a business purpose: telling employees, vendors, customers and others that existing shareholders were participating in the DIP was helpful to the company. The debtors also argued that the absolute priority rule was not implicated before plan confirmation and, in any event, that providing DIP financing was not the type of value that triggered an absolute priority analysis. In relevant part, the committee responded that the directors' business judgment could not be satisfied without a demonstration that the directors timely considered the rights of unsecured creditors. Additionally, with respect to absolute priority, the committee thought it self-evident that the shareholders were receiving an "investment opportunity" because they were pre-petition shareholders and not simply on account of the financing they were providing.

At the conclusion of the hearing, Judge Brian Kenney overruled the committee's objection to the shareholder DIP allocation, finding first that the absolute priority rule and the related *sub rosa* objection were potentially applicable for his analysis but concluding that the right to participate in the DIP was not granted to the shareholders because of their equity but instead was being granted on account of "their willingness to put in new money." He then concluded without any commentary that the shareholder allocation was an exercise of the debtor's sound business judgment, was negotiated at arms' length, and was in the best interest of the estate. Finally, Judge Kinney stated that he believed there was no harm to the general unsecured creditors by the debtors entering into the shareholder allocation because the outcome would be the same no matter: if the shareholders did not provide its allocation, the existing lender group would provide the $100 million and hold the same conversion rights.

As noted above, the committee subsequently filed the required notice that it was appealing Judge Kenney's ruling. The appeal remains unresolved at the time this article was completed.

CONCLUSION

What is clear from the cases reviewed above as well as other recent bankruptcy cases is that sponsors would like to obtain some recovery from companies that fail and turn to Chapter 11. What is also clear is that this is difficult if not impossible to accomplish that goal through the plan process, where the absolute priority rule clearly applies and where any potential "new value" contribution by the sponsor will be tested to ensure that the debtor obtains appropriate value. Accordingly, by seeking recoveries through a convertible DIP, sponsors are focusing on an earlier point in a company's Chapter 11 bankruptcy that is not as clearly subject to the same confirmation safeguards. From the perspective of other case creditors

including perhaps unsecured lenders, is this a bad outcome? The answer is "perhaps."

In some situations where the sponsor provides a convertible DIP, it appears likely that general unsecured creditors will receive a lower recovery. For example, the value that LATAM could distribute would not satisfy all unsecured creditors so providing old shareholders with some of that value (by providing a discount on future shares) would have reduced the recoveries to unsecured creditors. Judge Garrity was troubled by this. In contrast, where the $500 million Enviva DIP included uncontested conversion rights to whomever provided the DIP, including the one-fifth of the DIP facility provided by the sponsor, Judge Kenney was not troubled.

While the two situations were clearly fact specific, the two judges' views appear to be inconsistent. That is understandable, at least to some degree. Twenty-five to thirty bankruptcy judges (of the 345 bankruptcy judges in the country) in perhaps five different judicial districts hear the vast majority of large Chapter 11 cases. With that many judges, it is always likely that different views will emerge on difficult issues. And appeals take time.

In summary, given the modest downside to sponsors, it appears likely that sponsors will continue to push to provide convertible DIPs. And it appears just as likely that, at least where creditors' committees or other sophisticated creditors are organized opposite the debtor, there will be pushback. The result, as indicated by our highlighted cases, could continue to be inconsistent among different courts. For the reasons identified, such inconsistencies are unlikely to be resolved in the near term.

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