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Corporate Restructuring & Bankruptcy

Running On Empty

How the lack of DIP financing is reshaping the bankruptcy landscape.

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HISTORICALLY, the U.S. restructuring process has been characterized by policies that protect the continued operation of the debtor's business while the debtor develops a confirmable Chapter 11 plan approved by its creditors. Debtor-in-possession (DIP) financing was readily available to fuel the reorganizing business during this typically year-long, or longer, process—until now. In the current credit crisis, pre-petition lenders are skittish about financing a Chapter 11 case, and many traditional DIP lenders do not have the liquidity or willingness to step into the fray.

The dearth of DIP financing has caused many large businesses—Linens 'n Things and Circuit City are two recent examples—to abort the Chapter 11 process in its infancy and liquidate their businesses shortly after filing. The inability to finance post-petition operations will likely accelerate the trend toward pre-packaged plans and "pre-negotiated" asset sales in bankruptcy.

Pre-negotiated sales, our focus in this article, foreshorten the bankruptcy process and allow the sale of all or substantially all of the debtor's assets at the beginning of the Chapter 11 case. The debtor's "stub" Chapter 11 case carries on for the limited purpose, and greatly reduced cost, of administering the bankruptcy estate and distributing the sale proceeds to creditors.

In a typical pre-negotiated sale, the debtor files an executed asset-purchase agreement (APA) simultaneously with the Chapter 11 petition. The APA, which has been negotiated with an initial bidder, commonly referred to as a "stalking horse" bidder, is typically accompanied by a motion that asks the Bankruptcy Court to set the timetable and ground rules for an auction (the "Sales Procedures Motion"). The auction and court approval of the sale can be completed in as little as three months or, in expedient circumstances, faster. DIP financing is needed only to sustain the debtor's business through the conclusion of the auction and the closing of the sale. The expedited nature of pre-negotiated sales eschews the time-consuming disclosure statement approval and plan confirmation process that prolong the normal Chapter 11 case.

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Asset Sales in Bankruptcy

Sales of a debtor's assets outside a confirmed Chapter 11 plan are governed by §363 of the Bankruptcy Code.[1] A §363 sale is subject to court approval, after notice and a hearing. It is predicated on a Bankruptcy Court's finding that the proposed sale is the "best and highest" offer available and that the sale is in the best interest of creditors. In addition to a "distressed" sale price, §363 sales provide the purchaser with many benefits not available outside bankruptcy—chiefly, receiving a court order transferring the debtor's assets "free and clear"[2] of all liens, claims and encumbrances. The expunged claims attach to the sale proceeds. The transferred assets are whitewashed by the Bankruptcy Court order, delivering the purchaser a high degree of comfort that there will be no trail of surprise liabilities.[3]

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Under §365 of the Bankruptcy Code, the purchaser can also request that the debtor assume and assign executory contracts that it finds desirable and reject those it does not. Section 365 requires the debtor to assume the contract, cure any defaults and then assign it "as is" to the purchaser, though the counter-party can consent to negotiated modifications. Assets purged of claims and cherry-picked executory contracts are an intriguing cocktail for prospective purchasers.

Use of Pre-Negotiated Sales

Pre-negotiated sales are usually the product of a distressed company's recognition that even with the protection of the automatic stay barring the payment of pre-petition debt, it cannot self-finance a Chapter 11 case, and that refinancing and non-bankruptcy merger and acquisition options have been exhausted.

The current shortage of DIP financing means that a distressed company will likely not have the luxury of operating its business behind the protective shield of Chapter 11 while it develops a restructuring plan or conducts an orderly sale process. Often, prospective buyers identified in a pre-filing merger and acquisition process will indicate that any transaction must be accomplished through the §363 sale process. Thus, locating a stalking horse bidder becomes the best, or only, path for a distressed company—particularly if that bidder will provide the DIP financing for the distressed company's (hoped-for quick) journey through the §363 sale process.

Pre-negotiated sales often can be approved within 90 days of filing, thus providing a short horizon for DIP financing needs and making DIP financing more likely to be available. The existence of a stalking horse bidder also provides a prospective lender with significant assurance of a viable exit from bankruptcy. These abbreviated financing needs can be met by pre-petition lenders looking to support a short-term auction process, by specialized DIP lenders or, in many cases, by the stalking horse bidders themselves.[4] Pre-negotiated sales are often approved by Bankruptcy Court because they yield greater value than any other alternative—namely, fire sale liquidations or an unfinanceable (in the current market) reorganization process.

The Stalking Horse's APA

On the filing date, the debtor will file the Chapter 11 petition, the motion seeking court approval of the stalking horse sale (the Sale Approval Motion) with the APA attached as an exhibit. The stalking horse's APA becomes the template against which competing bids are measured. A stalking horse bidder has a huge advantage as it negotiates the terms that suit it, rather than accepting (usually without real opportunity for modification), terms negotiated by another bidder.

Courts favor §363 sale processes that eliminate all deal variables other than price. Competing bidders are required to bid against the stalking horse's APA. A competing bidder may offer a "mark-up" of the stalking horse's APA, but material changes are disfavored. Additionally, the attachment of conditions, such as due diligence or financing conditions, will usually doom any competing bid.

Sale Procedures Motion

The Sale Procedures Motion asks the court to approve the auction procedures, which are a condition to the stalking horse bidder's willingness to purchase the debtor's assets. The perceived value of proceeding with a stalking horse bidder is evidenced by the types of protections the court will routinely provide such a bidder. It is commonplace for a Bankruptcy Court to compensate the stalking horse bidder for its time and effort and the resources it expended. Sale Procedures orders usually adopt expense reimbursement and break-up fee provisions.

Expense reimbursements and break-up fees, which range from 1 percent to 5 percent of the purchase price, vary by jurisdiction. Delaware bankruptcy courts follow *In re O'Brien Environmental Energy Inc.*, requiring the break-up fee to meet the standard for an administrative expense under §503(b) of the Bankruptcy Code that the fee be "actually necessary to preserve the value of the estate."[5]

The Bankruptcy Court in the Southern District of New York adopted a formulation that analogizes the inquiry that would be made in the non-bankruptcy merger context: "When reasonable in relation to the bidder's efforts and to the magnitude of the transaction, breakup fees are generally permissible."[6] The Bankruptcy Court attempts to settle on a fee that compensates the stalking horse bidder for setting the floor price for the auction and yet is not so high as to chill competitive bids.

Provisions and Rules

Stalking horse bidders often successfully impose limited no-shop provisions. While pure no-shop or non-solicitation clauses are disallowed as contrary to bankruptcy policy, which obligates the debtor to find the highest possible bidder, limited no-shop clauses have been allowed so long as they do not chill the receipt of higher or better offers. Such clauses restrict the debtor from initiating contact with buyers, but allow it to respond to inquiries from interested bidders, usually on notice to the stalking horse bidder of any expression of interest. Procedures for determining what constitutes a qualified bidder and bid are also commonplace, enabling the stalking horse bidder to handicap the field.

The Sale Procedures Motion also includes the auction procedures that the stalking horse bidder and debtor have negotiated. The stalking horse bidder in a pre-negotiated sale has powerful leverage to negotiate bidding procedures that will favor it over any other qualified bidders. The bidding procedures will deal with a wide range of other issues such as the time and manner of notice of the sale, qualification of bidders, due diligence, deposit requirements and bidding increments.

Once the court grants the relief requested by the Sale Procedures Motion, the auction takes place on the schedule approved in the Sale Approval Motion. At the auction, the debtor selects, and the court approves, the highest and best offer. There are no guidelines for determining when a lower price bid may be a better offer, and the court has discretion to approve such bids on the specific facts of the case, but it is rare.

Recent Examples

Two recent Chapter 11 filings highlight the current market drive toward pre-negotiated sales. Chesapeake Corporation, a packaging company, lost access to borrowing and other capital needed to finance its debt during the credit crisis. Discussions with an ad hoc committee of Chesapeake's noteholders resulted in discussions with two members of the committee that led to a purchase agreement for substantially all of Chesapeake's assets.

On Dec. 29, 2008, Chesapeake filed for Chapter 11 relief in the Eastern District of Virginia, with a §363 sale motion to sell substantially all of its assets to the stalking horse bidders.[7] On Jan. 20, 2008, over the objection of the creditors' committee,[8] the court approved sale procedures substantially similar to those proposed by Chesapeake. The auction and sale approval hearing are set for late March. If successful, the company will have effectively completed its Chapter 11 process within 90 days.

On Jan. 20, 2009, the Delaware Bankruptcy Court approved the sale of Eclipse Aviation's assets to EclipseJet Aviation International, the stalking horse bidder and a subsidiary of ETIRC Aviation, which was Eclipse Aviation's single largest shareholder.[9] During 2008, Eclipse Aviation explored a number of financing and strategic alternatives, but finally determined that the only viable course of action was a sale of substantially all of its assets through a §363 sale.

The motion to approve procedures for the sale naming EclipseJet as the stalking horse bidder was filed on Nov. 25, 2008, the day Eclipse Aviation filed for bankruptcy. ETIRC, along with Eclipse Aviation's second largest shareholder, provided $12 million to $20 million in DIP financing during the approximately 60-day period from filing to the court's approval. EclipseJet purchased the assets for $28 million in cash plus $160 million in new equity notes, a number of which will be issued to existing creditors.

The §363 sales by Chesapeake and Eclipse Aviation involve sales to parties involved with the pre-petition debtor. This may also become more commonplace. Such parties have an advantage over third-party bidders because their insider knowledge of the debtor's business eases their due diligence, and allows them to more accurately price their bid and quickly negotiate the APA.

Cracks in the Ice

There are some signs that the deep freeze in DIP financing may be thawing. This would make sense given the significant benefits provided to a DIP lender under the Bankruptcy Code. Toward the end of 2008, Smurfit-Stone Container Corporation, a manufacturer of paper products struggling to service its debt as sales of its products plunged, unsuccessfully pursued out-of-court financing from 25 potential lenders.

Smurfit-Stone then turned its attention to securing DIP financing, which also proved challenging because of the size and complexity of the lending facility it required. Ultimately, the pre-petition lenders agreed to provide DIP financing. The DIP lenders secured a number of benefits that could not have been obtained pre-petition, including super-priority claim status, granting new senior priming liens on certain property, releases from the debtor of any pre-petition claims and an interest rate at LIBOR (London Interbank Offered Rate) plus 650 basis points on a $750 million facility.[10]

High DIP interest rates, a tight hand on the debtor's purse strings, and the court's blessing of pre-petition liens, collateral packages and releases are powerful inducements for DIP financing. The greater availability of DIP financing may not necessarily stop the trend toward pre-packaged and pre-negotiated sales, but will at least give debtors better leverage when negotiating such arrangements.

1. 11 USC §363 (section 363 sales).
2. 11 USC §363(f).
3. Although the scope of the "free and clear" order is broad, care must be taken to confirm its scope, especially with regard to environmental liabilities, tax and product liability claims.
4. DIP financing provided by the stalking horse bidder can increase its chance of success as a bidder since any other prevailing bidder will have to repay the DIP loan, which can also be used as a "credit bid" as part of the purchase price.
5. *In re O'Brien Environmental Energy Inc.*, 181 F.3d 527, 533 (3d Cir. 1999).
6. *In re 995 Fifth Avenue Associates, L.P.*, 96 B.R. 24, 28 (Bankr. SDNY 1989) citing *Cottle v. Storer Communication Inc.*, 849 F.2d 570, 578 (11th Cir. 1988).
7. *In re Chesapeake Corporation*, No. 08-36642 (Bankr. E.D. Va. filed Dec. 29, 2008).
8. The committee objected to, among other things, the short time in which to develop competing bids, the optionality of the purchase agreement that gives the stalking horse bidder a number of "outs" and an indefinite purchase price.
9. *In re Eclipse Aviation Corporation*, No. 08-13031 (Bankr. Del. filed Nov. 25, 2008).
10. *In re Smurfit Stone Container Corp.*, No. 09-10235 (Bankr. Del. filed Jan. 26, 2009). On Jan. 29, 2009, the U.S. Bankruptcy Court for the District of Delaware approved, on an interim basis, access to $550 million of the total facility.