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PRACTICAL CONSIDERATIONS FOR CHAPTER 11 RIGHTS OFFERING PROPONENTS

Although a backstopped rights offering can be a critical tool for successful chapter 11 exit financing, neither the Bankruptcy Code nor existing case law provides an express standard for approval of a rights offering or backstop agreement. In the absence of such a standard, it can be difficult to ascertain the likelihood of a challenge to these transactions until the debtor has already incurred significant resources and time. This article discusses certain risks and costs of prosecuting such a transaction that the debtor and other rights offering proponents should endeavor to consider, however difficult they may be to estimate.

By Scott R. Bowling and Shelby V. Saxon *

A backstopped rights offering[1] can be a critical tool for successful chapter 11 exit financing and, ultimately, a successful reorganization. From the debtor's perspective, they often check many restructuring needs: committed fresh capital, enhanced transaction certainty, shorter process duration, positive internal and external messaging, and support from a critical mass of impaired fulcrum security holders. But a rights offering that proposes allocating economic rights (particularly through a backstop agreement) favorably to holders of some but not all of the claims or interests within the same class under a chapter 11 plan involves heightened risks associated with legal challenges, increased litigation costs, and the risk of case delays that can significantly impact a business reorganization. With no express standard for approval of a rights offering or backstop agreement set forth in the Bankruptcy Code or case law, it can be difficult to ascertain the likelihood of a challenge to such a transaction until the debtor has already incurred significant resources and time-seeking approval of the transaction. Yet — particularly where a chapter 11 debtor requires postpetition financing and must negotiate terms such as the size of the facility, the maturity date, a draw schedule, and case milestones prior to seeking Bankruptcy Court approval of a non-*pro rata*

[1] A rights offering in bankruptcy is a financing transaction in which a debtor offers holders of existing securities or claims the right to purchase new equity or debt securities in the reorganized company upon emergence, typically at an attractive discount to the assumed value of the reorganized company or other inducements to incentivize participation. Rights offerings are often "backstopped," meaning that certain claimants commit capital to purchase both their shares and any unsubscribed shares of rights offering securities, usually in exchange for compensation.

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backstop or rights offering — the debtor and other rights offering proponents should endeavor to consider the risks and costs of prosecuting such a transaction, however difficult they may be to estimate.

LEGAL FRAMEWORKS FOR RIGHTS OFFERINGS OR BACKSTOP AGREEMENTS

The risks mentioned above stem in part from the relative lack of specific, published legal authority governing chapter 11 rights offerings or backstop agreements. Neither the Bankruptcy Code nor existing case law clearly delineates a legal standard for approval of a rights offering or backstop agreement, especially for a non-*pro rata* transaction. As a result, rights offering and backstop proponents are forced to shoehorn their proposed transactions into other chapter 11 legal frameworks, looking principally to case law for guidance. To date, the two leading cases on concepts applicable to rights offerings remain the decision of the U.S. Supreme Court in *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership* ("LaSalle")[2] and the decision of the United States Court of Appeals for the Eighth Circuit in *In re Peabody Energy Corporation* ("Peabody").[3] A discussion of those decisions and their application to rights offerings and backstop transactions follows.

In *LaSalle*, the Supreme Court held that a distribution of reorganized equity to prepetition equity holders constituted a distribution on account of such holders' prepetition equity interests under the debtor's chapter 11 plan, and given unsecured creditors' rejection of the plan, was required to comply with the absolute priority rule set forth in the Bankruptcy Code.[4] Critically, those prepetition equity holders had invested new money in exchange for their reorganized equity, but were the only parties given the opportunity to make such an investment.[5] The Court noted that the proponents of the equity investment could potentially demonstrate that the distribution of reorganized equity was not "on account of" prepetition equity interests, but was rather "on account of" the new money by showing that the new money was being invested on the best terms available to the debtor — *i.e.*, by providing evidence of a market test.[6] *LaSalle*'s ruling is otherwise known as the "new value corollary" to the absolute priority rule.[7]

In *Peabody*, the Eighth Circuit held, among other things, that the private placement of reorganized preferred equity to holders of only certain subsets of prepetition claims in a class did not constitute a distribution on account of such holders' claims.[8] Two critical facts supported the Eighth Circuit's decision. First, one portion of the private placement resulted from a postpetition mediation in which parties challenging the private placement failed to intervene despite having the ability to do so.[9] (In effect, the Eighth Circuit treated the postpetition mediation as a *de facto* public marketing process, perhaps because it took place in the public context of a pending chapter 11 case.) Second, another portion of the private placement was open to all holders

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[3] 933 F.3d 918 (8th Cir. 2019).

[4] *Id.* at 456–58. The absolute priority rule refers to the § 1129(b)(2)(B)(II) requirement that a holder of a claim or equity interest may not receive or retain under the plan property "on account of" such claim or interest unless each senior class has accepted the plan or is paid in full.

[5] *Id.* at 438–40.

[6] *Id.* at 457–58; *see also* Stephen D. Zide, et al., *Backstop and Private Placement Agreements: Commitment or Plan Treatment?* 30 No. 2 Norton J. Bankr. L. & Prac. NL Art. 4 (2021) ("Setting up a fair and open process in which other parties can make alternate proposals is important to distinguish the impermissible equity sale in *LaSalle*.").

[7] *Id.* at 458.

[8] 933 F.3d at 925.

[9] *Id.* at 921. For further detail on the mediation and other notable aspects of *Peabody*, see David A. Skeel, Jr., *Distorted Choice in Corporate Bankruptcy*, 130 Yale L.J. 366, 416–21 (2020).

of claims within the class who subscribed to the private placement relatively early in the debtor's chapter 11 plan process (and thereby committed capital for a longer period of time and with greater risk).[10]

Notably, neither *LaSalle* nor *Peabody* addressed a rights offering or a backstop agreement.[11] Yet their reasoning has been applied to rights offerings and backstop transactions in subsequent chapter 11 cases, at least in oral argument and parties' briefing. Specifically, rights offering and backstop proponents may need to demonstrate that the economic terms of the proposed transaction are the highest and best available to the debtor to prove that the non-debtor participants in the transaction are receiving their economic distributions on account of their new money and not on account of their prepetition claims or equity interests, both to satisfy the "fair and equitable" requirement of section 1129(b)(2) of the Bankruptcy Code and to satisfy the equal treatment requirement of section 1123(a)(4) of the Bankruptcy Code.[12]

The evidentiary requirements above are similar to those of an asset sale in bankruptcy where the debtor often satisfies such requirements by conducting a marketing process (in the context of a rights offering or backstop transaction, for exit financing) that is appropriate in the unique context of the debtor's reorganization. But, as with an asset sale process, parties seeking to challenge a rights offering or backstop transaction have both procedural and substantive objections at their disposal. Moreover, opponents, just by litigating, can "gum up the works" of the reorganization, increasing costs, attempting to extract holdup value, creating delays, and prompting colloquies on the record of proceedings that could cast doubt on the viability of a proposed transaction. This is particularly true in the context of non-*pro rata* transactions, where opponents can raise equal treatment objections that are not easily resolved. As discussed below, rights offering and backstop transaction proponents, in their strategic planning, should consider the costs and delays that are associated with challenges to such transactions.

CONSIDERATIONS FOR IMPLEMENTING A MARKET TEST

In every case, rights offering and backstop proponents should determine whether the debtor has actionable alternatives to the transaction under consideration. And "actionable" is the key word. For a potential alternative transaction to be "actionable," among other things, the transaction must make business sense for the debtor to undertake, taking into account transaction and legal risks, costs and uncertainty, and must be consistent with the debtor's objectives for its chapter 11 reorganization (typically, an expeditious emergence from bankruptcy, substantial deleveraging, and maximizing distributions to stakeholders). Many potential alternatives fail to satisfy one or more of these conditions through being either more expensive (*i.e*., failing to maximize value), less certain, inconsistent with the requirements of the debtor's postpetition financing, or inconsistent with the debtor's ability to reorganize.

The costs (largely, professional fees) and timeframes required to consider alternatives — *i.e.*, to conduct an appropriate marketing process — for a rights offering or backstop agreement can be significant. For example, it is common for a debtor conducting a marketing process to incur professional fees and require execution time in connection with each of the following, among others:

- designing an appropriate marketing and due diligence process;
- assisting in the allocation and management of scarce human and other resources within a reorganizing enterprise;
- analyzing precedent transactions and legal risks;
- meeting with the debtor's management and governing body to craft and, ultimately, approve the process;
- implementing the process and negotiating with participants;
- negotiating and drafting transaction documents with the "winning" participant (which, for a backstop agreement, are often sizable and complex);

[10] *Id.* at 922.

[11] Although the *Peabody* plan involved a rights offering, that aspect of the plan was not at issue before the Eighth Circuit. *Id.*

[12] Albeit a common argument, "[t]o date, efforts to derail backstop and private placement agreements on 1123(a)(4) grounds have failed." Zide, *supra* note 6. A private placement slightly differs from a rights offering: "In a private placement, a debtor will enter into an agreement to sell debt or equity to a select group of investors and not to a class at large." *Id.* For discussion on the statutory framework of Bankruptcy Code section 1123, see Lisa Laukitis et. al., *Equality of Treatment vs. Equality of Result*, Am. Bankr. Inst. J., January 2021, at 56.

- preparing a motion and supporting declaration for Bankruptcy Court approval of the transaction; and

- preparing witnesses (often from both the debtor's investment bank and governing body) to testify in support of the transaction and the adequacy of the marketing process.

In most cases, these components enable the debtor to present its *prima face* case in support of a rights offering or backstop agreement. Yet the prima facie case may not be sufficient to overcome determined opposition or even a Bankruptcy Court's own concerns with a proposed transaction.

RISKS OF INCREASED COSTS, DELAYS, AND UNCERTAINTY

Opposition to a proposed transaction complicates things, adding risk, time, and cost to the debtor's reorganization. As backstop agreements are typically approved by way of a motion under section 363(b) of the Bankruptcy Code (as a use of estate property outside of the ordinary course of business), the filing of such a motion initiates a contested matter in the Bankruptcy Court. Parties opposing the transaction thus have the ability under (among other rules) Rule 9014 of the Federal Rules of Bankruptcy Procedure to serve written discovery on the proponents of the motion and take depositions of witnesses. The costs of responding to such discovery and assisting witnesses in preparing for depositions are quite meaningful. So too are the costs of replying to objections and preparing for and attending an evidentiary hearing in the Bankruptcy Court. Even if the proposed transaction appears to satisfy the *LaSalle* and *Peabody* standards and the objections appear to have no merit, parties challenging a rights offering or backstop agreement can unilaterally impose substantial friction costs on the process. Those costs are borne directly by the debtor and indirectly by fulcrum security holders (and potentially also by junior parties in interest).

Parties seeking to challenge a rights offering or backstop agreement may not only object to the debtor's process (or asserted lack thereof) in entering into a backstop agreement or rights offering transaction but may also propose their own alternative financing transactions. This objection strategy occurred in *Peabody*, with the objecting parties proposing their own alternative transactions in an effort to show that the debtor's proposed private placement was not the highest and best available.[13] More recently, it occurred in *In re TPC Group, Inc.* ("TPC Group"),[14] where the rights offering and backstop proponents ultimately settled with the objecting parties. Notably, in *TPC Group*, the objecting parties proposed their own alternative transaction terms in the context of the debtors' process to market test the terms of their backstop agreement; in *Peabody*, by contrast, the postpetition mediation had ended before the objecting parties proposed their own alternative transactions, depriving such proposals of most of their legal force in a manner not unlike late objections to an asset sale.

The likelihood of opposition to a backstop agreement or rights offering is nowhere greater than in the context of a non-*pro rata* transaction, in which certain holders of claims within a class are proposed to receive benefits under the rights offering or backstop agreement relatively greater than those distributed to other holders of claims in the same class. Non-*pro rata* transactions raise the question whether there is a limit to the value that can be allocated to the "in" group at the expense of the "out" group. If such a limit exists, it follows that any value received by members of the "in" group in excess of that limit is likely to be argued to be on account of such holders' prepetition claims, in violation of the equal treatment requirement of section 1123(a)(4). And although, in some cases, the "best interests test" of section 1129(a)(7) of the Bankruptcy Code may establish such a limit, courts have not directly addressed the issue.[15]

Even in the absence of objections to a proposed rights offering or backstop agreement, the Bankruptcy Court has the ability to raise its own objections. For example, in *Pacific Drilling*, despite no objections to the proposed exit financing transactions having been filed, Judge Wiles raised concerns regarding the debtors' proposed rights offering, stating (among other things) that the

[13] *Id.* at 923.

[14] Case No. 22-10493 (Bankr. D. Del., 2022). The authors note that Baker Botts L.L.P. served as lead restructuring counsel to the *TPC Group* debtors.

[15] The "best interests" test under Bankruptcy Code § 1129(a) requires that:

> (7) With respect to each impaired class of claims or interests — (A) each holder of a claim or interest of such class —
>
> (i) has accepted the plan; or
>
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date . . . .

parties "need[ed] to convince [him] that the terms were reasonable as a financing matter."[16] The debtors revised the terms by eliminating the proposed $100 million private placement and modifying the backstop fee structure.[17] Judge Wiles subsequently approved the modified rights offering, noting, "I hope that in the future when these structures are presented, the parties will explore in more detail the issues and concerns that I have raised."[18]

In short, complying with the market-test implications of *LaSalle* and *Peabody* can be both costly and time-consuming, especially where litigation is involved.

RECENT CASE EXAMPLES

LaSalle and *Peabody* likely will not be the last published decisions on rights offerings or backstop agreements given the frequency with which rights offerings and backstop agreements are used to implement chapter 11 reorganizations. As discussed below, the recent cases of *In re LATAM Airlines*[19] ("LATAM Airlines") and *TPC Group* involved significant rights offering and backstop disputes that have brought heightened awareness to risks surrounding non-*pro rata* transactions.

LATAM Airlines illustrates certain types of arguments that rights offerings or backstop opponents can raise in trying to defeat a proposed transaction. In *LATAM Airlines*, the debtors entered into a restructuring support agreement (an "RSA") that contemplated an $8 billion capital raise through an equity rights offering and a convertible notes offering.[20] And while the terms of the RSA and the chapter 11 plan were highly complex (due in part to the cross-border nature of the restructuring), the rights offering transactions involved, among other things, a backstop fee equal to approximately 20% of the backstopped funding amount. In effect, the backstopping creditors had the ability to purchase a disproportionately greater share of notes related to their unsecured claims than other nonparticipating unsecured creditors within the same class.[21]

Certain unsecured creditors objected to confirmation of the plan, asserting, among other things, that (1) the plan violated the equal treatment requirement of section 1123(a)(4) of the Bankruptcy Code by giving the backstop parties favorable treatment on account of their claims in the absence of a market test[22]; (2) the backstop agreement required the debtors to make unreasonable payments in violation of section 1129(a)(4) of the Bankruptcy Code; and (3) the non-*pro rata* treatment of Class 5 claims amounted to impermissible plan "vote buying" in violation of section 1129(a)(3) of the Bankruptcy Code.[23] The Bankruptcy Court confirmed the plan over these objections, holding that the backstop agreements presented "fair and reasonable" terms that were "integral to the [d]ebtors' pursuit of" confirming their plan of reorganization.[24]

On appeal, the District Court held that the plan did not violate the equal treatment requirement, reasoning that the backstop transactions provided favorable treatment on account of new commitments, not on

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[16] Case No. 17-13193 (Bankr. S.D.N.Y., 2017), ECF No. 631, at 5.

[17] With the modification, the initially proposed 8% backstop fee would apply only to the uncommitted portion of the rights offering and a 5% fee applying to the remainder. *Id.*, ECF No. 629-1.

[18] *Id.*, ECF No. 631, at 11.

[19] 643 B.R. 756 (2022).

[20] For a discussion on the benefits and risks of RSAs, see David Skeel, *Pandemic Hope for Chapter 11 Financing*, 131 Yale L.J. Forum 315, 331 (2021). *See also* Stephen J. Lubben, *Holdout Panic*, 96 Am. Bankr. L.J. 1, 2–3 (2022) (discussing how an RSA combined with "discounts and backstop fees can provide substantial recoveries to those in the 'in crowd,' while other creditors of equal rank are only provided with the basic treatment set forth in the plan").

[21] *Id.* at 761.

[22] Specifically, the objecting creditors alleged that the backstop parties would have "the opportunity to purchase up to 86% of the" notes in question, "despite possessing only around 72% of unsecured claims," and would additionally receive the 20% backstop fee. *Id.* at 766.

[23] Under Bankruptcy Code § 1129(a)(3), "[t]he court shall confirm a plan only if . . . [it] has been proposed in good faith and not by any means forbidden by law." *See also* Shelby V. Saxon, *Chapter 11 Rights Offerings and Private Placements: How Creditors Can Strike A Windfall*, 94 Am. Bankr. L.J. 357, 368–69 (2020) (summarizing the common "three sub-arguments" that stem from objections on good faith grounds: "(1) that backstop participation contingent on a vote in favor of the plan amounts to improper solicitation of creditor votes (often referred to as "vote buying"); (2) that high backstop fees" fail to "maximize the value of the estate for all creditors; and (3) that certain negotiation tactics are improperly coercive").

[24] *LATAM Airlines*, 20-bk-11254, 2022 WL 790414 (Bankr. S.D.N.Y. Mar. 15, 2022).

account of prepetition claims.[25] Addressing the question of market testing, the District Court relied on the Bankruptcy Court's findings that the debtors had negotiated extensively with investment funds and considered multiple proposals, ultimately finding that "[t]he appellants' characterization of the negotiating process portrays it as more closed off than it was."[26] Further, the District Court held that the backstop fees were reasonable despite the fees being among the highest in any chapter 11 due to the "unusual length" of the commitment in a "particularly volatile industry."[27] Finally, the District Court held that the terms of the backstop agreement did not constitute impermissible vote buying, as the Bankruptcy Court had found that the backstop agreements were negotiated in good faith through an arm's-length process, and the appellant class had not shown otherwise.[28]

Similarly, *TPC Group* illustrates the procedural complexity that can be occasioned by parties' determined opposition to a non-*pro rata* backstop agreement. In *TPC Group*, the debtors entered into a prepetition RSA with, among others, members of an ad hoc group of noteholders holding over 80% of fulcrum prepetition notes.[29] The RSA contemplated both debt and equity rights offerings, in each case, backstopped by the ad hoc group. In addition to a put option premium and the ability to subscribe to reorganized equity at a discount to plan value, the backstop agreements provided for certain of the reorganized debt and equity to be directly allocated to the backstop parties (*i.e.*, the ad hoc group members). Holders of approximately 13% of the fulcrum prepetition notes outside of the ad hoc group (the "Nonconsenting Holders") opposed the backstop agreement.

The Nonconsenting Holders pursued a litigation-based strategy in the chapter 11 cases, demonstrating the breadth of parties' ability to impose risks, costs, and delay on a reorganization. That strategy comprised, among other things, the following components:

- cross-examining the debtors' witnesses at the "first day" hearing on the debtors' motion to obtain post-petition financing;

- commencing and prosecuting an adversary proceeding seeking to invalidate or subordinate senior secured notes held by the ad hoc group, including litigation through summary judgment;

- obtaining a stay of the Bankruptcy Court's order granting summary judgment in favor of the debtors and prosecuting an emergency appeal to the District Court;

- taking discovery and depositions of the debtors' witnesses in advance of the final hearing on the debtors' motion for postpetition financing;

- filing a written objection to the postpetition financing motion, cross-examining the debtors' witnesses at the hearing on the motion, and presenting oral argument in opposition to the motion;

- filing a written objection to the debtors' motion to approve the backstop agreement; and

- proposing alternative transactions in the context of the debtors' market-testing process.[30]

Although the *TPC Group* rights offering and backstop proponents ultimately settled with the Nonconsenting Holders, the process of achieving that settlement was plainly complex.[31]

[25] *LATAM Airlines*, 643 B.R. at 766.

[26] The District Court also noted "that the [d]ebtors' financial condition was sufficiently well-known that others had the opportunity to come forward with their own offers." *Id.* at 770–71.

[27] *Id.* at 769.

[28] *Id.* at 773 (reviewing the Bankruptcy Court's findings for clear error).

[29] *In re TPC Group Inc.*, Case No. 22-10493 (Bankr. D. Del., 2022).

[30] The objecting creditors asserted, among other things that the "exclusive" portion of the rights offerings would violate 1123(a)(4) equal treatment, and the proposed backstop fees were "unreasonable, untested, and unnecessary." *Id.*, ECF No. 624, at 5–11.

[31] The settlement resolved a significant amount of litigation. Pursuant to the settlement terms, the Nonconsenting Noteholders became "supporting noteholders" under the RSA and would collectively receive up to $3.65 million in professional fees. Prior to the settlement, the plan of reorganization was supported by 78% of the Class 3 noteholders; following the settlement, support for the plan increased to 96.3% of Class 3. *Id.*, ECF No. 772.

CONCLUSION

A rights offering and backstop agreement may be essential for exit financing in a chapter 11 reorganization. Yet it can be difficult to predict the costs, risks, and delays that may be associated with the prosecution of such transactions, particularly where those transactions result in non-*pro rata* economic returns to holders of claims or equity interests in a single class. Rights offering proponents should look beyond legal standards in their strategic planning and consider practical measures that, when accounted for in advance, can save time and money and reduce the execution risk of chapter 11 restructurings. ■