GIBSON DUNN

Getting Ready for the Next Cycle: Recent Trends and Developments in DIP Financings

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Introduction: The First and Last Thing a Debtor-in-Possession Needs is More Money

Cash Collateral/DIP Financing

- A bankruptcy most often begins with a liquidity crisis.
  - The debtor has run out of (or lost access to) cash and requires protection the automatic stay to stabilize its business and reorganize.
  - The first thing that a debtor needs is liquidity. That liquidity can come from the use of cash that is collateral for a secured creditor or from a loan made after the filing date.
  - These forms of financing are known as "Use of Cash Collateral" and "Debtor-in-Possession (i.e., DIP)" or "Postpetition" financing.

Introduction: The First and Last Thing a Debtor-in-Possession Needs is More Money

Exit Financing

- A bankruptcy ends with the confirmation of a Plan of Reorganization reorganizing the assets and liabilities of the debtor.
  - Most often part of the reorganization involves the payment of certain claims in cash.
  - The cash needed to consummate a confirmed Plan of Reorganization often comes from a new financing that closes on the "Effective Date" of the Plan of Reorganization, the proceeds of which are used in part to finance consummation of the Plan of Reorganization and to provide working capital and for general corporate needs going forward.
  - This financing is known as "Exit Financing."

Cash Collateral/DIP Financing Structures

Cash Collateral

If a debtor has sufficient cash and can provide adequate protection to (or obtain consent of) the secured party with respect to such cash, the debtor may be able to finance its case using cash collateral.

Equity cushion and adequate protection.

DIP Provided by Prepetition Lender ("Defensive DIP")

DIP financing may be provided to a debtor in the form of a post-petition loan by a prepetition lender.

A prepetition lender is the likely person to provide such a loan because such lender has a stake in the debtor's case and can consent to the priming of its liens and the use of its collateral.

DIP Provided by Third Party Lender

A DIP loan may be provided by a third party lender.

To prime existing lenders on a non-consensual basis involves risk to the debtor.

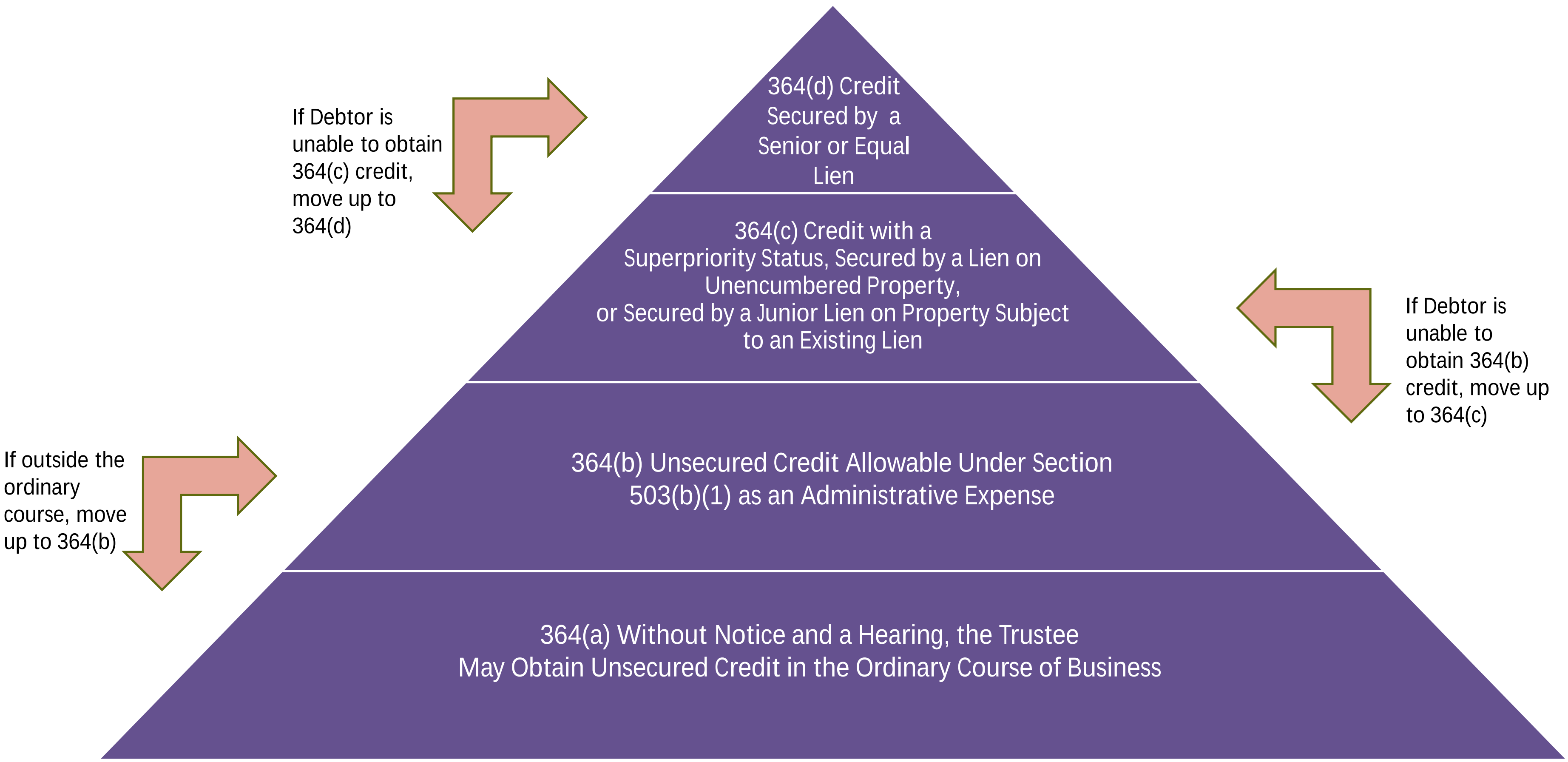
The debtor must show that there is sufficient value in the debtor's estate to provide adequate protection. Requires a trial (or valuation fight) which if unsuccessful may lead to the liquidation of the debtor.

DIP Financing Structures

Elements of a post-petition financing structure

- Use of Cash Collateral (Section 363 of the Bankruptcy Code)
- Ordinary Course (364(a) of the Bankruptcy Code)
- Administrative Expense Claim (364(b) of the Bankruptcy Code)
- Unsecured Post-Petition Loan (364(c)(1) of the Bankruptcy Code)
- Unencumbered Property Post-Petition Loan (364(c)(2) of the Bankruptcy Code)
- Junior Post-Petition Loan (Section 364(c)(3) of the Bankruptcy Code)
- Priming Post-Petition Loan (Section 364(d) of the Bankruptcy Code)

Bankruptcy Code Section 364 Hierarchy



Legal Standards and Procedural Requirements for Approval of DIP Financing

- Legal Standards
  - Section 364 of the Bankruptcy Code provides a multi-tiered protection scheme for postpetition lenders.
  - Under Section 364(a), a debtor in possession is authorized to incur unsecured debt "in the ordinary course of business" as an administrative expense without court approval.
  - The typical DIP Financing is not "ordinary course," so court approval is required.

Legal Standards and Procedural Requirements for Approval of DIP Financing

- Procedural Requirements
  - “Notice and hearing” are statutory requirements for the approval of DIP financing under Sections 364(b), (c) and (d).
  - Bankruptcy Rule 4001(c) contains detailed requirements for a motion for approval of a DIP financing.
  - Local rules in each district (as well as each judge’s particular practices) also should be considered.

Adequate Protection

- Section 364(d) expressly requires the provision of “adequate protection” to holders of prepetition liens that are to be primed by a DIP financing.
  - The payment of adequate protection is intended to preserve the value of a prepetition creditor’s interest in the secured property – i.e., to protect against any diminution in value of the lien.
- Adequate protection is an open-ended concept described in Section 361 of the Bankruptcy code. It may consist of
  - (1) periodic payments,
  - (2) an additional or replacement lien, or
  - (3) some other “indubitable equivalent” of the creditor’s lien interest.

Adequate Protection

- Some common forms of adequate protection:
  - Replacement liens on postpetition property (e.g. postpetition receivables generated);
  - Current payment of interest on the underlying debt and/or payment of such lender's professional fees.
- A sufficient equity cushion may also be adequate protection.
  - An equity cushion exists when the debtor has sufficient equity in the collateral to protect against its depreciation and the accrual of interest and charges.
- Adequate protection is only for the diminution in value of an interest in collateral. Where there is no diminution there is no entitlement to adequate protection.

Superpriority Administrative Expense Claims

- DIP Lenders will receive a superpriority claim, which would entitled the DIP Lender to be paid ahead of all other administrative claims
  - The Bankruptcy Code requires that administrative expenses be paid in full prior to unsecured creditors receiving any payment
  - Any plan of reorganization must provide that administrative expenses are paid in full.
  - Administrative expenses could be at risk if the debtor is administratively insolvent and is required to liquidate.

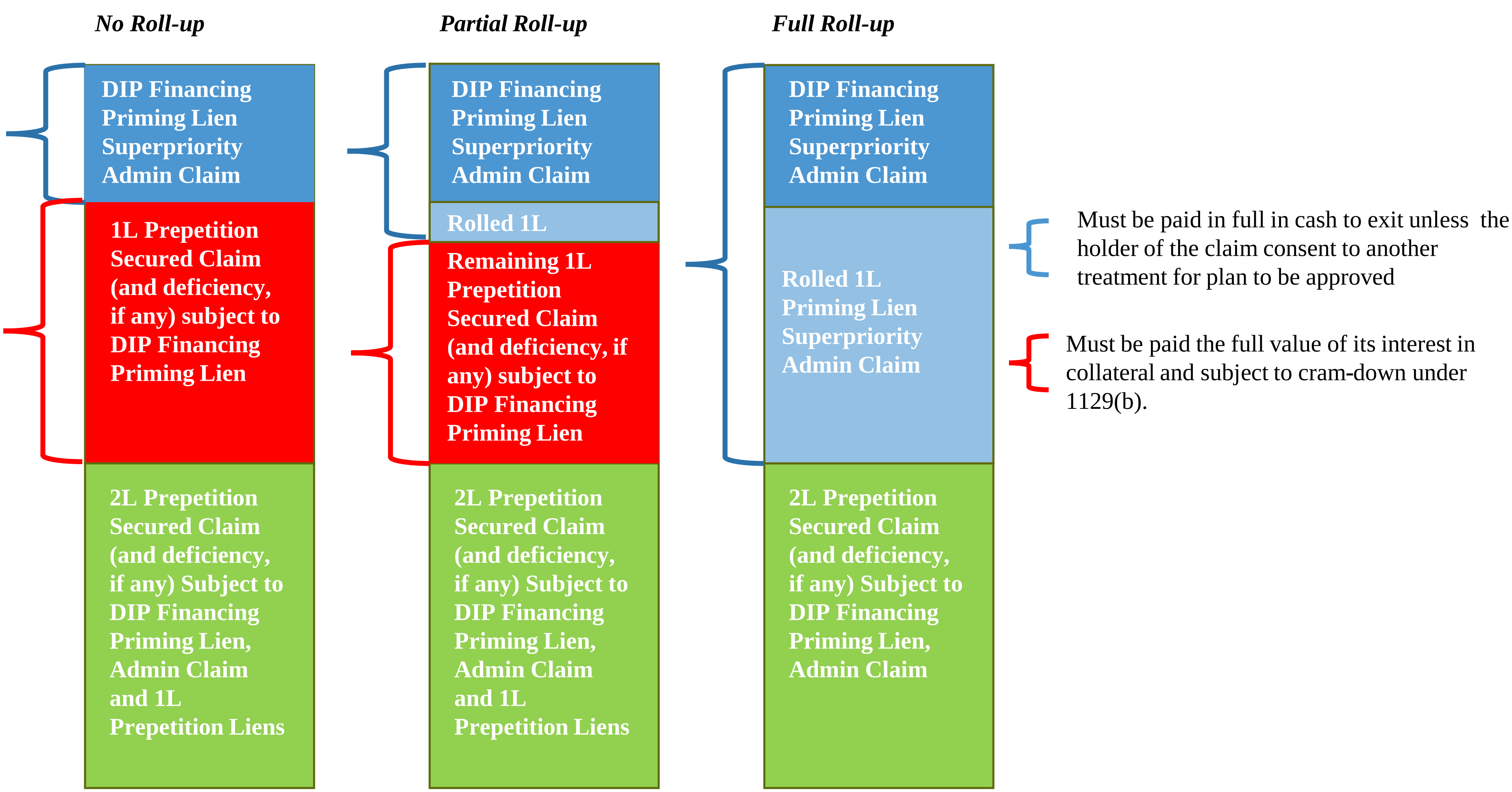
Liens on Avoidance Actions and Proceeds

- "Avoidance actions" are causes of action arising under sections 544, 545, 547, 548 and 549 of the Bankruptcy Code.
  - Include preferences and fraudulent transfers
- As part of their adequate protection package, DIP lenders will often seek liens on avoidance actions and the proceeds therefrom

Roll-Up and Cross-Collateralization

- Roll-up
  - A roll-up is the refinancing of prepetition debt with a post-petition loan.
  - The effect is to cause prepetition debt to have the benefit of the DIP Liens (subject to exception for challenge) and to have superpriority administrative expense claim status.
  - Effect of roll-up can be dramatic, as rolled-up debt cannot be crammed down.
  - As a general matter, courts have permitted roll-ups.
  - Flip-up Roll-ups of 2008

Roll-up of DIP Financing



Carve-Out

- DIP loans generally provide a carve-out from the DIP lender's collateral to ensure that certain costs of administering the bankruptcy case are paid.
  - US Trustee fees
  - Professional fees (typically covers professionals for debtor and statutory committees)
- Importance to Debtor
  - Burial Expenses
  - Ability to finance and continue exploring options
  - Professionals need to be paid and may not be able to instantly and ethically go pens down
- Importance to Lender
  - Carve-out comes ahead in DIP financing
  - In an admin insolvent case every dollar of carve-out is a dollar not recovered.

Budget: The 13-Week Cash Flow Projection

- DIP Financings and Uses of Cash Collateral are most often tied to a 13-week cash flow budget reflecting receipts and expenditures projected over a 13-week period.
    - The budget lays out specifically by line item the various receipts and expenditures.
    - Typically the budget is a “rolling” budget -- updated periodically (usually weekly) removing the lapsed week and adding a new week at the end, with the updates subject to the approval of the DIP Lender.
    - The DIP Loan Agreement will contain a covenant restricting expenditures and requiring receipts to fall within the budget on a line item by line item basis.
    - The future is hard to predict, and budget covenants are subject to variances by line item and in the aggregate across line items. These are individually negotiated but usually fall in the 10% to 15% range.

506(c) Surcharge

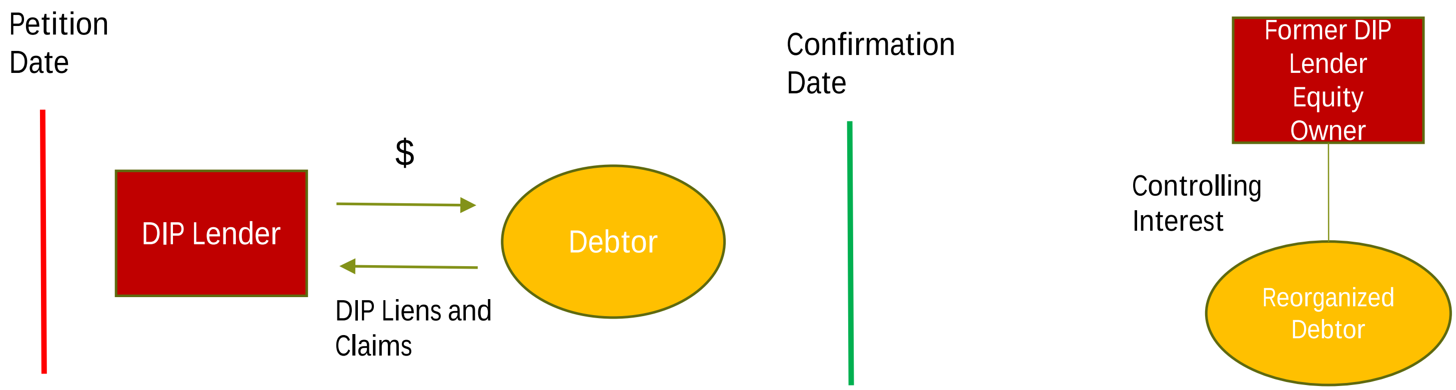
- As a general rule, expenses for administering a bankruptcy estate are paid out of the estate's unencumbered assets.
  - All unsecured creditors share in the cost
- Section 506(c) of the Bankruptcy Code provides for an exception to that rule
  - allows a debtor-in-possession to surcharge a secured creditor's collateral in bankruptcy to pay for the **reasonable, necessary costs and expenses** of preserving or disposing of collateral securing a secured claim, to the extent of any **quantifiable, direct benefit to the secured creditor** holding the claim.
  - Purpose of 506(c) is to prevent a windfall to secured creditor at the estate's expense
  - Oversecured Creditors are typically not subject to the surcharge because they are entitled to any reasonable fees, costs, or charges if so provided in their underlying agreement (see section 506(b) of the Bankruptcy Code).
- 506(c) Waiver. DIP lenders typically require that the Debtor waive its right to assert a 506(c) claim.

Events of Default

- DIP Loans will typically include the following events of default
  - Appointment of a trustee or receiver
  - Conversion of the case to a chapter 7
  - Milestones
    - Failure to comply with case milestones, i.e. deadlines for certain case objectives, including:
      - Filing a plan
      - Court approval of disclosure statement
      - Confirmation hearing
      - Entry of confirmation order

“Loan to Own” DIPs

- Some hedge funds and private equity investors employ “loan-to-own” strategies which may include DIP financing.
  - o Loan to own involves providing DIP financing in exchange for an equity stake in the reorganized company (or control over the asset sales process, giving the lender an advantage over other potential bidders in an auction of the debtor's assets).



Bankruptcy Waivers in Intercreditor Agreements

- Often in bankruptcy, parties must navigate intercreditor issues that are governed by intercreditor agreements.
- Certain rights may be waived by 2nd lien lenders in intercreditor agreements:
  - Right to seek adequate protection and/or object to cash collateral;
  - Right to contest 1st lien lenders' liens;
  - Right to current payment of interest;
  - Right to object to DIP financing supported by 1st lien lenders; and
  - Right to propose a competing DIP loan.

Exit Financing

- Similar to Other Non-Bankruptcy Financings
  - Conditioned on satisfactory confirmation order to a plan satisfactory to Lender
  - Substantial Consummation and Effective Date
  - Retention of Jurisdiction

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Professional Profiles

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David M. Feldman is a partner in the New York office of Gibson, Dunn & Crutcher and Co-Chair of Gibson Dunn's International Business Restructuring and Reorganization Practice Group.

Mr. Feldman's practice focuses on the representation of banks, hedge funds, private equity firms and companies in a variety of bankruptcy cases, out-of-court restructurings, and distressed asset and debt transactions. Mr. Feldman is consistently ranked as a leading Bankruptcy and Restructuring lawyer by *Chambers USA: America's Leading Lawyers for Business*, describing him as "an excellent strategist with an ability to guide his clients through restructurings efficiently and successfully," that he "is very smart," and "very experienced," and highlighting "his in-depth understanding of technical issues" and his "fantastic strategic vision." In addition, he is recognized by *Who's Who Legal Restructuring & Insolvency*, *IFLR1000* as a "Highly Regarded" Leading Lawyer, named a 2017 "Outstanding Restructuring Lawyer of the Year" by *Turnarounds & Workouts*, as one of the top Bankruptcy and Creditor-Debtor Rights lawyers by *The Best Lawyers in America*©, and by *Investment Dealers' Digest* as one of the Top 40 Under 40 Dealmakers of 2007. Mr. Feldman is a member of *Law360's* 2018 Bankruptcy Editorial Advisory Board which provides insight from experts in the field on how best to shape future coverage by the publication.

Mr. Feldman and his partners have developed a balanced restructuring practice with great depth on the Creditor/Investor side and the Company/Debtor side. Major recent in-court restructuring matters include: debtors' counsel to Brookstone Holdings Corp. (multichannel retailer); counsel to the Official Committee of Equity Security Holders in Synergy Pharmaceuticals Inc. (biopharmaceutical company); debtors' counsel to SH 130 (privately owned toll road that connects Austin to San Antonio); Chapter 11 of RCS Capital (financial services firm) for the Official Committee of Unsecured Creditors; restructuring and acquisition of control of Overseas Shipholding Group, Inc. (an international shipping company) for a group of investor/shareholders led by Paulson, BHR Capital and Blue Mountain Capital; Chapter 11 restructuring of Rural/Metro Corporation (major national ambulance company) for senior secured lenders agented by Credit Suisse; restructuring and acquisition of Wastequip Inc. (waste equipment manufacturer; previously owned by Odyssey) for group led by Credit Suisse and Centerbridge; restructuring and acquisition of control of William Lyon Homes (southern California homebuilder; previously controlled by William Lyon) for Luxor Capital; restructuring and acquisition of control of Trident Resources (a U.S./Canadian natural gas company) for group of investors led by Anchorage Advisors; and acquisition of major interest in Extended Stay (discount extended stay hotel chain; previously owned by Starwood) for Paulson (which acquired business together with Blackstone and Centerbridge).

Mr. Feldman received his Juris Doctor *cum laude* from the Benjamin N. Cardozo School of Law in 1993. He graduated from Cornell University in 1989. Mr. Feldman clerked for Chief Judge William H. Gindin, in the U.S. Bankruptcy Court, District of New Jersey, for two years following law school. Mr. Feldman is admitted to practice in New Jersey and New York.

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Mr. Wise advises agent banks in complex leveraged financings, including cross-border and multicurrency transactions, real estate financings, asset-based financings, leveraged acquisition financings and bank and bond/bridge and other financings, and represents lender and bondholder groups, financial institutions, hedge funds, private equity funds and corporate debtors in complex restructuring and reorganization transactions. He has extensive experience in complex special situations transactions, involving financial institutions, debtors and corporate issuers in second lien and subordinated financings, mezzanine structures, debtor-in-possession financings, Chapter 11 exit financings, rights offerings, recapitalizations, restructurings, work-outs, Chapter 11 cases, pre-packaged Chapter 11 cases and distressed debt purchases and sales.

Mr. Wise has experience in finance and restructuring transactions across industries, including healthcare, hospitality, real estate, telecommunications, steel, automotive, chemical, energy, transportation, telecommunications, financial institutions, and paper and forest products sectors. Mr. Wise is an expert in intercreditor relationships and complex debt structuring issues, and is frequently asked to advise in financial transactions involving complex intercreditor and debt structuring issues.

Mr. Wise is a member of the bar of New York and is admitted to practice in the federal courts in the Southern District of New York.

Prior to joining Gibson Dunn, Mr. Wise practiced with Kramer Levin Naftalis & Frankel LLP and Weil, Gotshal & Manges LLP.