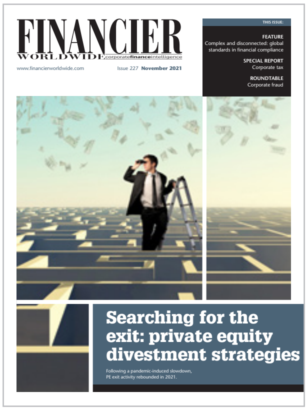

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Sale toggles in Chapter 11 plan processes

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The culmination of any successful restructuring under Chapter 11, large or small, is generally realised through confirmation of a Chapter 11 reorganisation plan or the closing of a sale under section 363 of the Bankruptcy Code. However, the paths to exit are not necessarily binary. It is not uncommon for debtors in bankruptcy to propose Chapter 11 plans that allow the debtor to 'market test' the company and its assets by running a simultaneous sale process which, if successful, may result in the debtor abandoning a reorganisation plan in favour of an alternative sale transaction that provides greater value to constituents. This is generally referred to as a sale 'toggle'. Properly structured and implemented, toggles can streamline and shorten a debtor's time in bankruptcy, drive consensus and provide greater confidence that the highest and best value for the enterprise or its assets is realised.

The ultimate structure and sequence of any toggle will vary depending on the facts of the case and the interests and motives of the key stakeholders. However, the typical structure of a toggle is for the debtor to file a Chapter 11 plan that contemplates a deleveraging of the business by converting some or all of the financial debt to equity, often coupled with a new money debt or equity investment by existing stakeholders. The plan will ideally be supported by a controlling amount of the debtor's senior lienholders, and potentially other key stakeholders in the case, memorialised through a restructuring support agreement; such creditors are generally known as 'supporting creditors'. That plan will also provide for a toggle, allowing the debtor to pursue a section 363 sale if a separate marketing process realises greater value than the enterprise value upon which the restructuring plan is premised. Like any other sale process in Chapter 11, the debtor will simultaneously conduct a marketing and auction process subject to bid procedures approved by the bankruptcy court. Prior to the deadline to vote on the Chapter 11 plan, the debtor will receive bids and, depending on the nature and value of bids received, determine in consultation with supporting stakeholders and any official committees whether to proceed with a sale of the company or to abandon the sale process and reorganise under the Chapter 11 plan.

Running a sale process that is designed to maximise value can facilitate both the sale and plan sides of any toggle. On the one hand, a sale process with the backdrop of a confirmable plan will effectively set a floor price for a sale and incentivise potential serious bidders to only make offers that will be seriously considered by the supporting creditors, thereby increasing the likelihood that the sale process will result in the highest and best bid for a company or its assets. On the other hand, if the plan side of the toggle is exercised, then the results of a properly conducted process designed to maximise value is strong evidence of value that can be used to defend against potentially expensive objections to confirmation by junior stakeholders that assert the plan does not properly allocate value to their interests. Further, the mere threat of pursuing a sale in lieu of a Chapter 11 plan may drive junior stakeholders taking unrealistic perspectives of value to consensually resolve potential objections to their treatment under the plan. As a result, regardless of whether the debtor or any supporting creditors prefer a sale or reorganisation, structuring a sale toggle to truly market test the company or its assets may increase the chances of a successful exit from bankruptcy.

One of the principal issues that must be addressed in structuring a toggle is the risk that potential bidders may be unwilling to undertake the time and expense of due diligence and submitting a bid, knowing that the debtor may ultimately abandon the sale process altogether and pursue a Chapter 11 plan reorganisation. A sale process that does not maximise bidder participation may depress value on the sale side of the process and may lessen the weight a court gives to the results of the sale process to the extent value is a contested issue on the plan side of the process. There are several common considerations that debtors and their professionals should assess in structuring a sale toggle to encourage an active marketing process.

First, as in standalone processes, debtors conducting a toggle process may allow potential purchasers to serve as a stalking horse purchaser with bid protections such as a breakup fee or expense reimbursement should the stalking horse purchaser not ultimately acquire the debtor's assets in the Chapter 11 case. The approach to permitting stalking horse purchasers and bid protections in a toggle process is not uniform. For example, in *In re CEC Entertainment, Inc.,* Case No. 20-33163 (Bankr. S.D. Tex.), the debtors proposed bid procedures that did not provide for or contemplate any stalking horse purchaser. In *In re NPC International, Inc.*, Case No. 20-33353 (Bankr. S.D. Tex.), the debtors' bid procedures order originally reserved the right to select a stalking horse and grant bid protections, and the debtors later selected a stalking horse bid with a breakup fee and expense reimbursement. Although not specifically labelled as a 'toggle,' in *In re JC Penney Company, Inc.,* Case No. 20-20182 (Bankr. S.D. Tex.),the debtors obtained advance approval to pay up to $3m in the aggregate to potential investors to cover their diligence costs, to attract bidders to participate in a 'market test' for the debtors' standalone Chapter 11 plan. The ultimate incentives offered to potential investors to encourage their participation in the sale side of a toggle process will depend on the facts of each case and will generally involve the input of both estate and lender professionals and advisers.

Second, in any toggle process, a debtor and its secured lenders may negotiate 'reserve prices' which, if exceeded by a qualifying bid, would result in the secured lenders' agreement to support a sale transaction in lieu of a reorganisation under a Chapter 11 plan. Again, the approach with establishing release prices is not uniform, and one of the common questions is when in the process should the reserve prices be disclosed to potential purchasers. For example, in *NPC International*, the reserve prices were published when the debtors first filed their motion for approval of bid procedures. In *CEC Entertainment*, the debtors' proposed bid procedures contemplated publishing reserve prices approximately a week prior to the bid deadline, but a month after the deadline for initial indications of interest. The difference in approaches in *NPC International* and *CEC Entertainment* is likely a product of multiple considerations, including whether delayed release would impact bidder participation, whether earlier release may artificially depress bid prices, and whether the supporting creditors were more interested in completing a sale or debt-for-equity reorganisation.

Debtors should also take steps to ensure that any information disclosed to voting stakeholders related to the Chapter 11 plan does not negatively impact the sale process. Under Bankruptcy Code section 1125, before creditors or other stakeholders may vote for or against a Chapter 11 plan, the debtor must distribute to voting parties a disclosure statement that is approved by the bankruptcy court as containing "adequate information". A common component of any disclosure statement is an analysis of the debtor's value upon confirmation of the plan. However, in a sale process, a debtor is generally reluctant to makes internal valuations available to bidders, because the premise of a sale process is to test the value of the company through the market. If a debtor's valuation analysis is exposed to the market during the bidding process, then this could have a detrimental impact on the price that would-be purchasers are willing to pay in a section 363 sale. *NPC International* provides a good example of how the negative impacts of this valuation concern can be avoided through proper sequencing of the sale and plan components of a toggle process. In that case, the court approved the debtor's disclosure statement without the debtors' valuation analysis attached, but with the requirement that such analysis be made public two weeks prior to the voting deadline for the plan, which was after the court-approved deadline for submitting qualified bids and holding an auction under the sale process. As a result, the debtors were able to complete their sale process and determine whether to toggle to a sale, before information that could have been harmful to the sale process was publicised as part of the debtors' plan confirmation process.

Using a properly structured toggle process, either as a market test for a Chapter 11 plan or to pursue in earnest alternative transactions, can help maximise value for all stakeholders in a Chapter 11 case. As a result, distressed companies and their advisers and stakeholders should continue to consider toggle plans and processes as they negotiate turnaround strategies. The decision whether to build a toggle in a Chapter 11 plan, and the ultimate structure of any toggle process, will depend on the facts and circumstances for each case, but a properly structured process can ultimately add greater certainty to a case, deter or streamline potentially expensive disputes over valuation, and ultimately make a debtor's restructuring efforts more efficient. ■

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