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# Pitfalls of Unequal Participation Rights in Syndicated DIP Financing

## *Is the Juice Worth the Squeeze?*

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For senior secured lenders, superpriority debtor-in-possession (DIP) financing secured by a priming lien senior to pre-petition secured debt has an extremely favorable risk/reward profile. If a company's pre-petition secured debt constitutes a syndicated loan facility, then it will typically seek DIP financing from a group of lenders under the loan facility that constitute "required lenders" (referred to herein as the "majority lender group").

The "required lenders" are vested with most voting and consent rights under the loan agreement, including the right to direct the agent with respect to collateral matters, and usually consist of lenders holding at least 50.1 percent of the loans. Immediately after the commencement of a bankruptcy case, the lenders outside of the majority lender group (referred to herein as the "minority lenders") are frequently given the opportunity to participate in the commitments under the DIP facility in an amount equal to their *pro rata* share of the aggregate DIP commitments based on their pre-petition loan holdings as of the bankruptcy filing date.

However, the majority lender group does not always offer minority lenders an equal opportunity to participate in the DIP financing. For example, in the *JC Penney*[1] and *Ascena Retail Group Inc.*[2] bankruptcy cases, DIP financing commitments provided by the majority lender groups were not offered to minority lenders on a *pro rata* basis. Because the pre-petition secured debt held by the majority lender group and minority lenders was the "fulcrum" security entitled to a majority of the reorganized equity value of the debtors in both of these cases, the DIP financing's cost was effectively being funded by the minority lenders (*i.e.*, the majority lenders' incremental recovery from the DIP financing was coming at the direct expense of the minority lenders' recovery on their pre-petition loans).

In both cases, the objections of the minority lenders to such treatment were ultimately consensually resolved.[3] Although there is no case law directly addressing the right of minority lenders to participate in priming DIP financing arranged and funded by majority lenders, courts may consider the following issues if and when they rule on an objection by the minority lenders on such grounds.

## Heightened Scrutiny over the Reasonableness of DIP Objection

DIP financing must satisfy the statutory requirements set forth in § 364 of the Bankruptcy Code. It can only be secured by liens *pari passu* or senior to liens securing pre-petition debt if junior secured financing is (1) unavailable, and (2) the pre-petition lenders' liens are adequately protected.[4] Debtors typically prefer to obtain *pari passu* or senior DIP financing from a majority lender group for the following reasons: (1) the debtors can negotiate with the majority lender group a restructuring-support agreement (RSA) describing the terms of a reorganization plan and thereby lock up an impaired accepting bankruptcy class (66 $^{2}/_{3}$ percent in amount of total claims voting; majority in number of claim holders voting); and (2) the majority lender group can direct the agent with respect to collateral matters, including consenting to the debtors' use of cash collateral and subordination of the liens securing the pre-petition debt to the DIP liens and related matters (including adequate protection).

In situations where the majority lender group proposing the DIP financing also holds the "fulcrum" security (often the pre-petition senior secured term loan), the debtor might be less likely to aggressively negotiate the economic terms of the DIP given that such holders will likely become the owners of the controlling equity interests of the reorganized debtor entity. When that dynamic is present, any "above market" economics embed-

1 *See In re JC Penney Co. Inc., et al.*, Case No. 20-20182 (Bankr. S.D. Tex.) (DRJ), Debtors' Emergency Motion for Entry of (I) an Interim and Final Order (A) Authorizing Debtors to Use Cash Collateral, (B) Granting Adequate Protection to the Pre-Petition Secured Parties, and (C) Scheduling a Final Hearing; and (II) a Final Order (A) Authorizing the Debtors to Obtain Post-Petition Financing Pursuant to Section 364 of the Bankruptcy Code, (B) Granting Liens and Superpriority Claims, (C) Modifying the Automatic Stay, and (III) Granting Related Relief [Docket No. 38] (DIP financing exclusively provided by *ad hoc* group holding 70 percent of term loans with no syndication to minority term loan lenders or *pari passu* secured noteholders).

2 *See In re Ascena Retail Grp. Inc.*, Case No. 20-33113 (Bankr. E.D. Va.) (KRH), Debtors' Motion for Entry of Final Orders (I) Authorizing the Debtors to Obtain Post-Petition Financing, (II) Authorizing the Debtors to Use Cash Collateral, (III) Granting Liens and Providing Superpriority Administrative Expense Status, (IV) Granting Adequate Protection to the Pre-Petition Lenders, (VI) Modifying the Automatic Stay, (VI) Scheduling a Final Hearing, and (VII) Granting Related Relief (Dkt No. 18) (limiting non-*ad hoc* group participation in aggregate DIP commitments to 50 percent of their *pro rata* share based on pre-petition loan holdings).

3 *See In re Ascena Retail Grp. Inc.*, Dkt. No. 565 (describing settlement embodied in first amendment to RSA providing minority *ad hoc* group of pre-petition lenders with participation rights in DIP financing in connection with their joinder to RSA); *In re JC Penney Co. Inc., et al.*, Dkt. No. 562, at ¶ LLL (describing terms of settlement providing cross-holder group that held 12 percent of senior secured first-lien term loans and 16 percent of senior secured first-lien notes with the right to participate in $53.5 million (or 11.89 percent of the $450 million aggregate roll-up DIP commitments)). In contrast to the JC Penney DIP settlement, the terms of the settlement in *Ascena* were not disclosed. The authors represented the minority *ad hoc* group in *Ascena*.

4 11 U.S.C. § 364(d).

ded in the DIP will effectively be distributed to the DIP-financing lenders at the ultimate expense of the minority lenders not participating in the DIP financing. Although the debtors will solicit competing DIP-financing offers from third parties, this is usually a challenging option since junior DIP financing is generally not available, and the debtors would expect vigorous litigation from the majority lenders over a lack of adequate protection if they propose DIP financing secured by liens senior or *pari passu* to the pre-petition secured debt.[5]

In addition to evaluating compliance with the Bankruptcy Code and applicable rules, bankruptcy courts will typically defer to the debtor's "business judgment" in deciding whether to approve the DIP financing.[6] However, in situations where the cost of the DIP financing is at the upper range of the market *and* minority lenders are excluded from *pro rata* participation, the courts might be more inclined to question the debtors' business judgment for at least two reasons.

*First*, the minority lenders might argue that excluding them from the ability to participate in their *pro rata* share of the DIP financing undermines the debtors' argument that the pricing and fees of the proposed DIP financing are reasonable and appropriate under the circumstances. Faced with this type of objection, a bankruptcy court could conclude that DIP financing is priced high relative to actual risk where the majority lenders are insisting on excluding or limiting the participation of minority lenders under the presumption that giving more lenders the ability to participate in a DIP financing — particularly lenders who will be harmed if they are excluded from participation — would have the effect of driving down pricing and fees. In fact, minority lenders may submit a competing DIP-financing proposal on more favorable terms than the majority lender group's proposed DIP financing to demonstrate to the bankruptcy court that, among other things, the cost of capital of the majority lender's DIP financing reflects their leverage owing to their majority position rather than the actual fair market cost of capital.

*Second*, since the cost of the DIP financing will likely affect the pre-petition secured lenders' recovery (if they are undersecured), the court may view unequal opportunity to participate in the DIP financing as unfair and as a way of skirting certain protections in the Bankruptcy Code and/or loan agreement requiring equal treatment among the same class of lenders with respect to plan and sale distributions. This might be particularly true if the proposed financing includes a roll-up of pre-petition debt, because in that case the pre-petition debt held by the minority lenders (and majority lenders with respect to their non-rolled up loans, if any) is being primed by both the new-money portion of the DIP financing *and* the pre-petition debt of the majority lenders rolled up as part of the DIP financing.[7] A roll-up is already subject to heightened scrutiny by the bankruptcy court because it elevates the priority of pre-petition debt outside of a reorganization plan and may therefore be inconsistent with the plan-confirmation requirement under 11 U.S.C. § 1123(a)(4), which mandates the same treatment for each claim of a particular class under a plan unless the holder agrees to less favorable treatment.[8]

## Scrutiny of the *Sub Rosa* Plan Objection

Where a majority lender group conditions DIP financing on the debtors' entry into and compliance with an RSA, and the prosecution of a specified reorganization plan along the timetable set forth in the DIP credit agreement and RSA, parties-in-interest may object to the DIP financing on the grounds that it is a "*sub rosa* plan." A *sub rosa* plan is the principle, first established by the Fifth Circuit in *In re Braniff Airways Inc*. and later applied by many other courts, that a "debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa*," typically through the sale of substantially all assets under 11 U.S.C. § 363 or through DIP financing under 11 U.S.C. § 364.[9] The *sub rosa* plan DIP-financing objection generally seeks to deny court approval of the proposed DIP financing on the grounds that the terms thereof would lock the debtor into pursuing a particular reorganization plan, and subvert the plan-confirmation process and accompanying protections afforded to parties of interest in connection therewith.[10]

Exclusion of minority lenders from *pro rata* participation in a DIP financing that has elements of a *sub rosa* plan might result in heightened scrutiny from the bankruptcy court on the grounds that such financing locks the debtors into a reorganization plan that cannot satisfy the plan-confirmation requirement set forth in § 1123(a)(4).[11] Essentially, minority lenders could argue that § 1123(a)(4) is violated when the DIP financing converts into exit financing and the minority lenders are not given the same opportunity to participate therein by virtue of their exclusion from or limited participation.[12]

Section 1123(a)(4) may still constitute grounds for denying a syndicated DIP financing that does not allocate any commitments to minority lenders on a *pro rata* basis, even if the proposal does not convert into exit financing. For example, the U.S. Bankruptcy Court for the Southern District of

5 *See In re LSTAP US LLLP*, 2011 WL 671761, Case No. 10114125, at *3 (Bankr. D. Del. Feb. 18, 2011) (citing *In re Swedeland Dev. Grp. Inc.*, 16 F.3d 552 (3d Cir. 1994)).

6 *Official Comm. of Subordinated Bondholders v. Integrated Res. Inc. (In re Integrated Res. Inc.)*, 147 B.R. 650, 656 (S.D.N.Y. 1992) ("The business-judgment rule 'is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action was in the best interests of the company.'"); *In re Los Angeles Dodgers LLC*, 457 B.R. 308, 313 (Bankr. D. Del. 2011) ("Under the [business-judgment rule], courts will not second-guess a business decision, so long as corporate management exercised a minimum level of care in arriving at the decision.").

7 This article does not address the argument made by the cross-holder group in *JC Penney* that a non-*pro rata* DIP financing with a roll-up of pre-petition debt violates the *pro rata* sharing provision of the applicable pre-petition credit agreement requiring that any term loan lender share ratably in any amount that it receives in payment of obligations due under the term loan credit agreement with other term loan lenders who may not receive the same proportional amount. *See JC Penney*, Case No. 20-20182, Dkt. 469 ¶ 28, Objection of the *Ad Hoc* Cross-Holder Group, Dkt. 469.

8 *See, e.g.*, 3 *Collier on Bankruptcy* ¶ 364.06[2] (Richard Levin & Henry J. Sommer eds., 16th ed.) (describing how practice of roll-ups "is of questionable validity under the general bankruptcy principle favoring equal treatment of similarly situated creditors and disfavoring payment of pre-petition debt outside of a reorganization plan").

9 *Pension Benefit Guar. Corp. v. Braniff Airways Inc. (In re Braniff Airways Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983).

10 *See, e.g., In re Belk Props. LLC*, 421 B.R. 221, 225-26 (Bankr. N.D. Miss. 2009) (denying motion to approve secured DIP facility where DIP financing (and entry of DIP order) made reorganization plan "*fait accompli*").

11 *See In re Latam Airlines Grp. SA*, 620 B.R. 722, 819 (S.D.N.Y. Bankr. 2020) (holding that a provision in DIP financing providing the lenders, who were pre-petition equityholders, the ability to exchange DIP claims for equity at 20 percent discount to plan value constituted an impermissible *sub rosa* plan because it "necessarily determines plan terms giving the Debtors the right to distribute equity in the reorganized Debtors to the [DIP lenders] — at a 20 percent discount to plan value — that will not be subject to court review").

12 *See In re Washington Mut. Inc.*, 442 B.R. 314, 360 (Bankr. D. Del. 2011) (holding that plan that excluded small creditors of class from participating in rights offering available to large creditors violated § 1123(a)(4)).

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New York in *In re LATAM Airlines Group S.A.*, in denying approval of the proposed DIP financing, found that it violated the absolute-priority rule because one of its tranches was being funded exclusively by shareholders on account of their pre-existing equity holdings and could be repaid in equity at a 20 percent discount to plan value.[13] The court specifically rejected the debtors' argument that § 1129 "only applies in a plan-confirmation process" and not in a "pre-confirmation loan" context.[14] Thus, minority lenders could argue that § 1123(a)(4) should similarly apply with respect to allocation of DIP-financing commitments and require providing minority lenders with the opportunity to participate in such commitments *pro rata*, even if there is not a DIP-to-exit-financing component, because the majority lenders' participation in the DIP-financing commitments is on account of their pre-petition loan holdings.

## Conclusion

Failure to offer minority lenders the opportunity to participate in their *pro rata* share of DIP financing commitments based on their pre-petition loan holdings could well result in minority lenders organizing and objecting to the proposal on various grounds, including those set forth herein. This, in turn, may result in higher professional fee costs and an increased risk of the bankruptcy court ultimately denying the DIP financing proposal, among other things. Thus, in deciding whether to offer *pro rata* participation in a DIP financing to minority lenders, the majority lenders must decide whether "the juice is worth the squeeze." abi

13 *In re Latam Airlines Grp.*, 620 B.R. at 801.
14 *Id.* at 798.