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Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

Michael Eisenband
Consulting Editor
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AMERICAN BANKRUPTCY INSTITUTE

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THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING

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Consulting Editor

Michael Eisenband

Advisory Board

Carlin Adrianopoli

Amir Agam

Michael Buenzow

Robert Del Genio

Michael Katzenstein

Steven Simms

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TABLE OF CONTENTS

CHAPTER EXCERPT

12 THE BACKSTOP RIGHTS OFFERINGS: SECURING CAPITAL DURING YOUR RESTRUCTURING PROCESS

LEGAL PERSPECTIVE

Mayer Brown LLP

Adam C. Paul, *Partner*

Lucy F. Kweskin, *Partner*

Tyler Ferguson, *Partner*

When a Chapter 11 debtor seeks to emerge from bankruptcy through a plan of reorganization[1] it must demonstrate feasibility by, among other things, showing sufficient funding for its go-forward, reorganized operations. Some or all of this funding can come through a rights offering — in which the reorganized debtor issues debt or equity instruments to raise funds. Backstop agreements have become a frequent companion to bankruptcy rights offerings and commonly involve existing creditors or equity holders guaranteeing that the rights offering will be fully subscribed by agreeing to purchase any unsubscribed rights in exchange for a fee.

This chapter provides an overview of how backstop agreements are utilized in Chapter 11 bankruptcy cases, addresses common critiques of backstop agreements and analyzes recent trends in backstop agreements through the lenses of both case law and key terms in the underlying backstop agreements.

Overview of backstop agreements

The rights offering

If a debtor elects to obtain exit funding in full or in part through the issuance of new equity[2] or debt instruments, it will seek bankruptcy court authorization to conduct

[1] Alternatives to a Chapter 11 plan of reorganization include a sale of substantially all assets under section 363 of the bankruptcy code or a plan of liquidation.

[2] Under section 1145(a)(1), securities in the reorganized company may be issued without traditional securities registration and compliance if securities are issued: (i) under a plan of reorganization; (ii) by the debtor, an affiliate of the debtor, or a successor to the debtor; and (iii) in exchange for claims against or interests in the debtor, or "principally" in exchange for such claims or interests and partly for cash or property. Section 1145(a)(2) also provides an exemption for offerings of securities through warrants, options, rights to subscribe, or conversion privileges when the original security is issued in compliance with section 1145(a)(1).

a rights offering in which a select group of creditors or existing equity holders may purchase the instrument being issued.[3] Participation in a rights offering is typically offered to all eligible claimants (typically those that meet certain accreditation requirements) in a particular class of claims on a pro rata basis. Participation is also usually solicited concurrently with (and as an inducement for a class of creditors to vote in favor of) plan confirmation. For this reason, court approval is most commonly sought in conjunction with the filing of the debtor's disclosure statement so that the debtor may work toward getting the rights agreement subscribed concurrently with obtaining the necessary votes for plan confirmation.

In order to incentivize participation in the rights offering, it is very common for the debt or equity instrument involved to be issued at a discount — sometimes a very steep discount — to the estimated enterprise value of the reorganized debtor. A debtor may subject its proposed rights offering to market testing, but this is not especially common and is not a legal requirement to obtain court approval of the backstop agreement.

Purpose, logistics and importance of backstop agreements

To ensure the necessary capital is raised via the rights offering, it is common for a debtor to enter into an agreement with either a third party or, much more commonly, a group of existing creditors or equity holders (who, many times, are also taking part in the initial rights offering). This is done to "backstop" the initial rights offering by agreeing to purchase any unsubscribed portion of the initial rights offering after the offering period expires. Backstop parties are compensated for undertaking the financial risk incumbent with backstopping a rights offering through fees that may be paid in cash, in kind with the instrument being offered, or a combination of both.

[3] It is also possible, in a circumstance where a debtor negotiates a restructuring support agreement or plan support agreement prior to bankruptcy, that a debtor will have the terms of a rights offering agreed when it enters bankruptcy.

Backstop agreements can provide a myriad of benefits to the debtor's bankruptcy estate, principally that the reorganized debtor can meet its post-bankruptcy capital requirements. To confirm a Chapter 11 plan, the debtor must establish plan feasibility, which requires the debtor to show that the confirmed plan is not likely to be followed by a liquidation or need for further financial reorganization — under Section 1129(a)(11) of the Bankruptcy Code. Backstop agreements ensure that the rights offering will be fully subscribed, providing committed financing for the reorganized debtor to establish the feasibility of its Chapter 11 plan.

Backstop agreements also play an important role in inducing support for the plan because, as expanded on in the next section, backstop agreements typically require the backstop parties to agree to vote in favor of the debtor's plan. Obtaining backstop support from existing creditors or equity holders — as opposed to obtaining third-party exit financing — can also boost recoveries for creditors and, thus, generate support for the plan. In this way, backstop agreements can, and often do, help generate consensus in Chapter 11 cases. Although backstop agreements are a mechanism typically employed in large Chapter 11 cases, there are few written opinions on the topic because of its ability to drive consensus, and where objections are made, it is common for consensual resolutions to follow.

Critiques of backstop agreements

Notwithstanding the fact that backstop agreements are commonly utilized and approved in Chapter 11 cases, they can be the subject of significant criticism most typically from creditors that are excluded from the opportunity to participate in backstopping the initial rights offering and would otherwise have wished to participate. The first type of common criticism argues that the use of a backstop agreement is inconsistent with provisions of the bankruptcy code that mandate that similarly situated creditors be treated the same and require that a Chapter 11 plan be proposed in good faith.

Payment of backstop fees to only some similarly situated creditors may allow a subset of creditors — typically larger creditors — to receive higher recoveries than others with the same priority claims in violation of Section 1123(a)(4) of the Bankruptcy Code, which requires that a plan provide the same treatment for each claim or interest of a particular class and Section 1129(b)(1) of the Bankruptcy Code, which prohibits unfair discrimination between similarly situated creditors.[4] Another common argument is that the payment of lucrative backstop fees in exchange for plan support violates Section 1129(a)(3) of the Bankruptcy Code, which requires a plan to be proposed in good faith and not by any means prohibited by law because the payment of backstop fees constitutes impermissible vote buying.[5]

The second common type of criticism focuses on the amount of compensation provided to the backstop parties and whether such compensation would be justified if the rights offering and backstop were subjected to market testing. A core argument made on this point is that backstop fees are not warranted and would be less substantial if the rights offering and backstop were subjected to a comprehensive market test from third-party financing sources. A related argument is that proceeding with a backstop of the rights offering and limiting the oversubscription rights of participants creates an artificial need for backstop parties, generates unnecessary costs for the estate and creates unmerited upside for the subset of parties permitted to participate in the backstop. Relatedly, parties that make these arguments also commonly note that there is typically limited visibility into how participation rights in a rights offering are distributed, which makes it difficult to accurately analyze the reasonableness or necessity of fees paid to backstop parties. To this point, lack of visibility is sometimes used to support arguments that backstop agreements approved in prior bankruptcy cases should not be used as a basis to approve a backstop agreement proposed by a debtor in a new bankruptcy case.[6]

Additional critiques of backstop agreements and rights offerings focus on the ability of only a portion of the debtor's creditors to participate.[7] For example, it is common for participation in a backstop agreement to be limited to entities that are U.S.-based companies or that qualify as accredited investors. This precludes many trade creditors and other non-financial parties from participating.

[4] *See infra* Trends in Backstop Agreements – Case Law.

[5] *See, e.g., In re Seadrill Limited*, The SVP Parties Objection to Debtors' Motion for Entry of an Order (I) Authorizing Entry into the Backstop Commitment Agreement, (II) Approving the Payment of Fees and Expenses Related Thereto, and (III) Granting Related Relief, (Bankr. S.D. Tex. Aug. 23, 2021) [Docket No. 864] ("The significant benefits afforded to the Backstop Creditors through the Backstop Letter compared to the de minimis risks the Backstop Creditors are incurring in connection with their purported Backstop commitments raise the specter of impermissible 'vote buying' through the provision of disproportionate benefits to the Backstop Creditors in exchange for their entry into the PSA and support of the resulting plan.")

[6] *See, e.g., In re SunEdison*, Objection of CNH Partners, LLC and AQR Capital Management, LLC to Debtors' Motion for Entry of an Order Authorizing and Approving (I)(A) Entry into the Backstop Commitment Letter, (b) Equity Commitment Agreement, (c) Payment of Fees and Expenses and (II) the Rights Offering Procedures and Related Forms, Case No. 16-10992 (Bankr. S.D.N.Y. May 16, 2017) [Docket No. 3133].

[7] *See, e.g., In re Gulfmark Offshore, Inc.*, Objection of Jeffrey L. Boyd & Magdalena L. Boyd to (I) Approving Rights Offering (II) Authorizing the Debtor to Conduct the Rights Offering in Connection with the Debtors Plan of Reorganization (III) Approving the Form of Materials Necessary for the Consummation of the Rights Offering (IV) Authorizing the Debtor to Assume the Backstop Commitment Agreement and Pay the Backstop Obligation and (V) Granting Related Relief and (VI) Disclosure Statement for Chapter 11 Plan of Reorganization of Gulfmark Offshore Inc., Case No. 17-11125 (Bankr. D. Del. June 14, 2017) [Docket No. 130] (arguing that debtor's proposed rights offering impermissibly took value from retail noteholders for the benefit of certain accredited investors).

Recent attention on backstop agreements, such as Judge Wiles's opinion in the *Pacific Drilling*,[8] have emphasized these concerns. However, objections of the type discussed previously and concerns like those raised by Judge Wiles have not prevented backstop agreements from continuing to be approved. Instead, objections, which are often used to generate leverage as opposed to true opposition to the terms of the backstop agreement, continue to be generally resolved by consensual resolutions rather than court decisions.

Trends in backstop agreements

Case law

As noted previously, bankruptcy court approval of backstop agreements is most commonly sought at the disclosure statement approval stage of a Chapter 11 bankruptcy case and, in some circumstances, the plan confirmation stage. As such, it is common for objections to be made not only to specific mechanics of the proposed backstop agreement, but also as support for an objection to the adequacy of the disclosure statement (i.e., objections that the disclosure statement contains inadequate information concerning the backstop) or to plan confirmation (i.e., aspects of the backstop render the plan non-confirmable). Although rare, as addressed next, courts have raised their own concerns over backstop agreements even where no objections to the backstop were filed.

This was the case in *In re Pacific Drilling S.A.* when the U.S. Bankruptcy Court for the Southern District of New York was presented with an uncontested motion to approve a backstop agreement. Despite no parties objecting to the terms, Judge Wiles initially refused to approve the backstop agreement citing his concerns that (i) the 8% backstop fee did not bear any relationship to the actual risk being undertaken by the proposed backstop parties, (ii) a $100 million private placement designated for the backstop parties was a disguised over-allocation of rights for these creditors and (iii) the backstop fees, which were to be paid in kind with deeply discounted securities, provided the backstop parties with an impermissible windfall. In a bench ruling dated October 1, 2018, however, Judge Wiles ultimately approved the debtors' proposed rights offering, on a slightly modified basis over his own reservations while further articulating his concerns with backstop agreements.[9] The decision generated some concern that it would be more difficult to obtain court approval of backstop agreements in future cases.

These concerns were, at least in part, obviated following the U.S. Court of Appeals for the Eighth Circuit's decision *In re Peabody Energy Corp.*,[10] in which the appellate court approved the debtors' entry into the backstop agreement notwithstanding creditor objections and held that the debtors' Chapter 11 plan complied with Section 1123(a)(4) of the Bankruptcy Code, which requires the same treatment for each claim or interest of a particular class, despite providing more favorable treatment to creditors that agreed to backstop the debtors' rights offering by paying the participating creditors a significant premium and allowing them to purchase preferred stock in the reorganized debtors at a deep discount. In so ruling, the Eighth Circuit placed significant emphasis on the risk undertaken by the backstop parties as a justification for their significant compensation. Since the *Peabody* decision, numerous backstop agreements have been approved with no significant court decisions reported.

A separate issue related to backstop agreements was addressed in a decision from the *In re MPM Silicones, LLC* bankruptcy case, in which the bankruptcy court addressed an objection to a proposed backstop agreement.[11] Specifically, the objecting parties argued that the payment

[8] *In re Pacific Drilling S.A.*, Bench Decision Regarding Motion for Approval of Terms of Equity Rights Offering and Equity Commitment Agreement, Case No. 17-13193 (Bankr. Ct. S.D.N.Y. Oct. 1, 2018) [Docket No. 631].

[9] *Id.*

[10] 933 F.3d 918 (8th Cir. 2019).

[11] *See In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

TABLE 1. Overview of key cases involving backstops

Case	Initial Rights Offering Amount	Instrument Being Backstopped	Discount to Plan Value (%)	Backstop Fee (%)	Payment Method	Backstop Party/Parties
24 Hour Fitness (2020)	$65 million	Preferred Equity	N/A	10	In Kind	Ad Hoc Group of Term Loan Lenders and Unsecured Noteholders
American Commercial Lines Inc. (2020)	$150 million	Preferred Equity	N/A	7	In Kind	Term Loan Lenders
Berry Petroleum (2016)	$335 million	Preferred Equity	N/A	7	In Kind	Unsecured Noteholders
Breitburn Energy Partners LP (2016)	$775 million	Common Equity	N/A	10	In Kind	Unsecured Noteholders
California Resources Corporation (2020)	$450 million	Common Equity	35	10	In Kind	Term Loan Lenders
CHC Group (2016)	$300 million	Second-Lien Convertible Notes	10	10.3	In Kind	Plan Sponsors and Unsecured Noteholders
Diamond Offshore Drilling (2020)	$125 million	First-Lien Notes	N/A	9	In Kind	Senior Noteholders
EP Energy Corporation (2019)	$475 million ($325 million of newly issued shares and $150 million in debt converted to equity)	Common Equity	25.7 (with respect to converted debt) and 35% (for newly purchased Common Equity)	8	In Kind	First-Lien Noteholders
Erickson Inc. (2016)	$20 million	Common Equity	10.0	6	In Kind	Second-Lien Lenders
Fieldwood Energy LLC (2020)	$20 million	Common Equity	N/A	8	In Kind	First- and Second-Lien Term Loan Lenders

(*Continued*)

TABLE 1. Overview of key cases involving backstops (*Continued*)

Case	Initial Rights Offering Amount	Instrument Being Backstopped	Discount to Plan Value (%)	Backstop Fee (%)	Payment Method	Backstop Party/Parties
Garrett Motion Inc. (2020)	$632 million	Series A Preferred Equity	N/A	8.44	In Kind	Plan Support Parties/Investors
Hertz (2020)	$1.635 billion	Common Equity	N/A	10	In Kind	Plan Sponsor
Linn Energy Inc. (2016)	$530 million	Common Equity	20.0	4	Cash	Secured and Unsecured Noteholders
Lyondell (2009)	$2.8 billion	Class B Equity	39.8	2.5	In Kind	Plan Sponsor
Peabody Energy (2016)	$750 million	Common Equity	45.0	8	In Kind	Second-Lien Noteholders and accredited holders of allowed general unsecured claims
Seadrill (2021)	$350 million	First-Lien Notes	N/A	10.9	Cash/In Kind	First-Lien Credit Agreement Claimants
SunEdison, Inc. (2017)	$300 million	Common Equity	2.4	7	In Kind	Second-Lien Creditors and General Unsecured Creditors
The Gymboree Corporation (2017)	$80 million	Common Equity	35.0	5	In Kind	First-Lien Term Loan Lenders
Ultra Petroleum Corp. (2020)	$42.5 million	Common Equity	N/A	7.5	In Kind	Consenting Lenders Under RSA
Washington Prime (2021)	$325 million	Common Equity	32.5	9	Cash	Ad Hoc Bank Group holding corporate-level bank debt
Windstream Holdings Inc. (2019)	$750 million	Common Equity	37.5	8	In Kind	Certain holders of First-Lien, Second-Lien and unsecured debt and an Ad Hoc Group of other 1L Lenders

subordination provisions in their intercreditor agreement with certain junior creditors (who were backstop parties) restricted those junior creditors from receiving payments under the backstop agreement. The bankruptcy court concluded that payments made to the junior creditors pursuant to the backstop agreement did not violate the subordination provisions of the parties' intercreditor agreement and the backstop creditors were permitted to keep the backstop fees they received from the debtor[12]. The bankruptcy court reasoned that although the cash to be paid to the junior creditors "could be viewed as Common Collateral. . . the payment . . ., if made, [would] be based on the [junior creditors'] rights under the Backstop Agreement, not in respect of remedies as secured creditors. Such payment would not be on account of a secured obligation or the junior and secured creditors' mutual collateral but, rather, a separate, unsecured obligation undertaken by the debtors to the defendants for backstopping new exit financing for the debtors beyond the time provided in the Backstop Agreement."[13] Thus, creditors that are parties to a backstop agreement may, under certain circumstances, be able to receive payments on account of their participation in a backstop so long as the receipt of such payments is not proscribed by the specific terms of their intercreditor agreement.

Overview of key cases involving backstops

The rights offerings and backstop fees for several large cases are summarized in Table 1 herein.

Key terms

Compensation & commitment period

Backstop agreements are heavily negotiated, and certain provisions are often highly situation dependent. Compensation or the fees to be provided to the backstop parties is, perhaps, the most heavily negotiated provision in backstop agreements. In the cases surveyed in Table 1, backstop fees ranged from 2.5% in *Lyondell* to 10.9% in *Seadrill*, with fees typically paid in kind or with a combination of cash and securities. As shown in the table, the amount of backstop fees paid does not necessarily rise proportionately with the amount of the initial rights offering being backstopped. The *Lyondell* case demonstrates this, as the backstop parties were paid a 2.5% backstop fee despite the initial rights offering involving the issuance of $2.8 billion in Class B Equity. Backstop commitment periods vary significantly and can be difficult to predict, running between 27 and 261 days of cases surveyed. There are no clear trends over the last approximately ten years or in more recent cases on this point.

In more recent cases from the last two years backstop fees appear to have commonly been between 7% and 10%, with a slight preference in favor of higher backstop fees. For example, *California Resources Corporation* involved a 10% backstop fee payable in equity of the reorganized debtor at the same per share price as the rights offering (i.e., at a 35% discount to the $1.65 billion plan equity value). The *24 Hour Fitness* case involved a 6% backstop fee paid in-kind along with a 4% upfront equity investment right payable in reorganized common equity issued through the debtors' plan to the debtor-in-possession lenders that backstopped the debtors' rights offering. In the *Washington Prime* case, the backstop parties were paid a 9% backstop fee on the $325 million rights offering paid in kind with common shares priced at a 32.5% discount to plan equity value. Finally, in Seadrill's 2021 bankruptcy case, the backstop parties' fees were comprised of a cash payment of $20 million (equal to approximately 6.67% of the total rights offering) and 4.25% of the equity in the reorganized debtor issued under the rights offering.

Other key provisions

While backstop fees are typically highly negotiated, backstop agreements also contain a number of core provisions that are largely consistent between backstop agreements.

[12] *Id.* at 753.

[13] *Id.*

— **Plan voting:** One common provision is a requirement that the backstop parties support the debtor's plan by voting in favor of it. On this point, it is not uncommon for backstop parties to also be parties to a Plan Support Agreement ("PSA") or Restructuring Support Agreement ("RSA") requiring them to support and vote in favor of the debtor's plan.

— **Expense reimbursement:** Backstop parties typically negotiate for and receive the right to be reimbursed in cash for their reasonable and documented costs and expenses incurred in connection with negotiating and entering into the backstop agreement. Reimbursement rights may be subject to agreed caps, but under certain circumstances and based on the parties' negotiations, backstop parties may be able to obtain an uncapped reimbursement right.

— **Conditions precedent to backstop party's obligations:** There are a number of customary conditions to the backstop parties' becoming obligated to fulfill their obligations under the backstop agreement, including (a) the occurrence of specified events in the bankruptcy case (such as confirmation of the debtor's plan and other milestones intended to move the case forward), (b) the confirmation order becoming final and non-appealable, (c) the occurrence of the plan's effective date, (d) receipt of an agreed form of funding notice and (e) the representations and warranties in the backstop agreements remaining true and correct. In addition to such customary conditions, the debtor and the backstop parties may negotiate and include in the backstop agreement additional, situation-specific conditions to the backstop parties' obligation to perform under the backstop agreement.

— **Transfer of backstop rights:** Backstop agreements commonly limit the transfer of backstop rights (and the backstop parties' other claims or equity against the debtor) to specifically defined parties, most commonly other backstop parties or parties who otherwise agree to be bound by the backstop agreement and any operative RSA or PSA.

Conclusion

Rights offerings have proven to be an increasingly common method by which debtors raise necessary capital to emerge from bankruptcy. In connection with rights offerings, backstop agreements have similarly proven to be critical to building consensus and guaranteeing that debtors are, in fact, able to raise necessary capital in order to achieve plan confirmation and emerge from bankruptcy. Although backstop agreements have faced certain criticisms, the Eighth Circuit's decision in *Peabody Energy* suggests that, at a minimum, backstop agreements remain a very viable tool for debtors to employ in connection with raising capital to exit bankruptcy.

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