Lawyer Insights

Does an RSA with Plum Exit Financing Constitute Vote Buying? Examining the Peabody Situation

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Published in Creditors Rights Coalition | October 23, 2022

Over the past decade, or so, we have seen situations in Chapter 11 cases where groups of creditors contracted with debtors for the exclusive right to provide new money on extremely favorable terms, with significant "backstop" fees paid in connection therewith, and other creditors in the same class were excluded from participating in such investments. E.g., *Peabody Coal*, *CHC Helicopter*, *Pacific Drilling*, *Momentive* and most recently, *LATAM Airlines* and *TPC Group*.

The specific mechanics of these transactions vary but they generally arise in DIP loans (e.g. Toys R Us), or in exit financings to be implemented under a reorganization plan. In connection with plan exit financings, such exclusive new money arrangements have typically been tied to restructuring support agreements (RSA's) under which the new money investors – – which, significantly, have the size to control the vote of their class and deliver acceptance of the debtors proposed plan – – receive very favorable returns on their new investments. Similarly situated creditors that are not invited to participate in the exclusive new money investment, do not get to participate in the favorable new investment – – except where they put up a successful fight to be included, as, for example, we recently saw in the *TPC Group* case, where Cerberus Capital was initially excluded.

Below is a high level summary of some of the issues relating to such exclusive investment opportunities by creditors in Chapter 11 cases, which will likely be resolved on a case by case basis depending on the specific facts and circumstances presented and the strength and approach of the excluded creditors opposing such transactions. Generally, assuming the debtor can show that the new exclusive financing has been appropriately market tested, or adequately "shopped," and that the financing is necessary for the reorganization to succeed, courts will have a hard time rejecting them if plan confirmation can't otherwise be achieved. Objecting parties' best response to these exclusive financing opportunities is to propose a more favorable financing package which, they would argue, should be embraced by the debtor as a better deal. But, if excluded creditors proposing the competing financing cannot deliver the class, it may be difficult to prove that the alternative financing package is a "higher and better" financing package.

Violation of Section 1123(a)(4)

Objecting parties have argued that such exclusive financing arrangement violate 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." It is often said that while claimants in a class need not receive the exact same recovery, at the very least all claimants in a class must have the same opportunity for recovery. Several courts have seemed responsive to such arguments.

For example in *Pacific Drilling*, Judge Wiles rejected an uncontested motion to approve an equity commitment agreement that would have provided lenders that agreed to backstop a $500 million rights offering with an 8% backstop fee and a "private placement" opportunity to purchase $100 million of reorganized equity at a 46.9% discount to plan value. The Court explained that those exclusive opportunities gave rise to "an equal treatment problem that's deadly to your plan, and I mean deadly." Judge Wiles explained: "The theory of the Bankruptcy Code is that when the big creditors sit in a room and negotiate a deal, the little creditors who are in the same boat get the same deal. The Bankruptcy Code does not permit the unequal treatment of creditors in the same class; it also does not permit the payment of extra compensation to large creditors in exchange for their commitment to vote for a plan." Judge Wiles further stated that "the problem with special allocations in rights offerings, or with private placements that are limited to the bigger creditors who sat at the negotiating table, or big backstop fees that are paid to the bigger creditors who sat at the negotiating table but that are not even open to other creditors (and in particular to other creditors in the same class), is that it is far too easy for the people who sit at the negotiating table to use those tools primarily to take for themselves a bigger recovery than smaller creditors in the same classes will get."

In *Momentive*, Judge Drain rejected an agreement that would have provided a 5% fee to backstop a $600 million rights offering priced at a 15% discount to plan value. Judge Drain explained that he did not "have sufficient evidence that a right that is being offered to all other members of the class for merely the fifteen-percent discount is not fair without another five-percent recovery which the rest of the class is not being offered." On the other hand, in *LATAM Airlines*, Judge Garrity recently approved an exclusive financing arrangement under which the exclusive commitment creditor group, which controlled the class vote, received far superior treatment under their exclusive new money investment compared with recoveries of excluded creditors in the same class, including substantial backstop fees even on their own commitments. In *LATAM Airlines*, Avenue Capital was among the excluded creditors.
Violation of LaSalle

Objecting parties have also argued that exclusive financings offered to select groups with class control violate LaSalle because a bona fide market test is lacking. In *Bank of America Nat. Trust and Savings Assoc. v. 203 N. LaSalle St. P'ship*, 526 US 434 (1999) ("*LaSalle*"), the U.S. Supreme Court held that, in a plan not accepted by all impaired creditors, exclusive investment opportunities granted to existing stockholders to buy discounted equity could not constitute legitimate consideration for a new money investment if such investment opportunity is on account of, or in consideration for, the existing equity interests. That would violate the absolute priority rule. The Supreme Court found that a market test was necessary to prove that an exclusive new money investment opportunity was not given to equity on account of their existing equity interests. In other words, roughly, the exclusive opportunity had to be appropriately marketed – – so as to ensure it was the equivalent of a new money market-priced investment and not on account of an existing claim or interest. Courts have applied the same rule to creditor claims. That seems like an obvious conclusion, and that is why in response to an exclusive new money investment granted to a select few, the objecting parties' typical tactic would be to propose a more favorable financing package which, they would argue, should be embraced by the debtor as a better deal. If, however, the group of creditors granted the exclusive investment opportunity can deliver the votes to have the debtor's plan accepted, and the excluded creditors proposing the competing financing cannot, is the exclusive financing package a "higher and better" financing package?

In *TPC Group*, which was ultimately resolved consensually by allowing Cerberus and others to participate, Judge Goldblatt, prior to the consensual resolution, commented on whether the exclusive offer was market tested, and therefore not given to the exclusive group of creditors solely on account of

their existing claims and ability to deliver plan acceptance: "[A]t some level it does seem as if, for example, the Supreme Court's decision in 203 North LaSalle is highly relevant to that question and that, when you're asked is the reason a party, a creditor or interest holder receiving certain treatment on account of their claim or interest, on the one hand, or on account of a plan transaction on the other, that the way that's answered is by market testing. And I've got some concerns that these transactions here aren't market tested, which, if right, would counsel in favor of the view that it's actually consideration being given on account of the claims, which would give rise to claims of discriminatory treatment."

Conclusion

It is not clear what the future holds for these exclusive financing arrangements. What appears clear, however, is that: groups of investors will seek to maximize their recoveries, even if similarly situated creditors are excluded; debtors will do whatever is necessary to confirm a plan; excluded creditors will oppose being left out; and bankruptcy courts will tend to remain in the business of confirming plans.

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Originally published on October 23, 2022, as a contribution to the Creditor Rights Coalition Contributors Speak Up series. Read the full version here.