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How To Reduce Or Eliminate The Need For Exit Financing

Law360, New York (April 02, 2014, 2:37 PM ET) -- There are at least three strategies for reducing or eliminating the need for new exit financing: (1) reinstating the prepetition secured debt, (2) allowing the secured lender to retain its liens while making deferred cash payments on the secured debt, or (3) reaching a consensual agreement with the prepetition lender. The first two strategies usually involve a "cramdown" or "cram-up" plan.

A "cramdown" plan is any plan that a court confirms over the objection of creditors. The term "cram-up" is sometimes used to refer to a cramdown plan where the plan is confirmed over the objections of a secured lender and is favored by junior creditors. In either scenario, the debtor is using the Bankruptcy Code to confirm a plan over the objection of one or more significant creditors.

In many cases, a debtor may not be able to confirm a cramdown plan because the Bankruptcy Code contains stringent requirements for the confirmation of a plan.

Cramdown plans are often the subject of intense and protracted litigation and therefore may not be a useful alternative to exit financing. For example, in some cases, a debtor needs to emerge from Chapter 11 within a certain time frame, such as when a debtor-in-possession loan is set to expire and there is not an opportunity to renew the post-petition financing. Relying on a cramdown plan where there is a hotly contested confirmation hearing will pose a substantial risk to the debtor's ability to emerge from Chapter 11.

Cramming Down the Secured Lender

One of the more common methods of reducing or eliminating the need for new exit financing is by confirming a plan that compels a secured lender to retain its liens and take deferred cash payments in satisfaction of its claim. Under Section 1129(b)(2) of the Bankruptcy Code, a court can confirm a plan over the objection of a secured lender if the plan does not discriminate unfairly and is fair and equitable with respect to the impaired class of claims. See 11 U.S.C. § 1129(b)(1).

With regard to secured claims, a plan is fair and equitable if the plan provides that the secured lender retains its lien and receives on account of its claim deferred cash payments equal to the amount due or the value of the collateral, whichever is less. See 11 U.S.C. § 1129(b)(2).

Calculation of the deferred cash payments requires the court to analyze the future stream of payments under the prepetition secured loan and determine the appropriate interest rate for the deferred cash payments. In addition, nonprice terms of the prepetition secured loan, such as whether the loan is recourse or nonrecourse, may also affect the interest rate carried by the deferred payments. Calculation of the interest in this type of cramdown plan is a heavily litigated issue.

While a cramdown plan does not provide any new funding to a reorganized debtor, it can lessen the amount of exit financing required by reducing the cash payments that the debtor funds on the effective date of the plan. However, if the retained liens are substantial, then a cramdown plan may not leave sufficient unencumbered assets for the debtor to obtain exit financing, which is often in the form of secured debt.

Reinstating Secured Prepetition Debt

Reinstating prepetition debt is a strategy whose use has surged in recent years due to the strong swing in the credit markets during the last decade and the difficulty that some debtors have had in obtaining exit financing. Before the 2008 financial crisis, the credit markets were extremely lax, allowing borrowers to negotiate very light covenants and become highly leveraged by taking on several tranches of debt.

Lending standards and terms have tightened remarkably since 2008, creating a situation where a debtor may prefer to reinstate or restructure its prepetition loan, or may have no alternative but to do so. Some debtors have used the Bankruptcy Code to shed several tranches of undesirable debt, while reinstating one or more loans that have favorable terms.

Under Section 1142(2) of the Bankruptcy Code, a debtor can reinstate a defaulted prepetition secured loan if the plan:

- Cures all defaults, other than ipso facto clauses;
- Reinstates the maturity date;
- Compensates the lender for damages incurred as a result of reasonable reliance on any contractual provisions in the debt instrument; and
- Compensates the lender for pecuniary losses suffered as a result of a nonmonetary event of default.
- Does not otherwise alter the lender’s legal, equitable, or contractual rights, including any security interests granted to the lender.

If these conditions are met, then the lender is unimpaired, is deemed to have consented to the plan, and is not entitled to vote on the plan.

Lenders are often loathe to allow loan reinstatements because the original terms of the loan are likely too loose in today’s lending environment. To avoid a loan reinstatement, lenders will frequently argue that the plan is not feasible (as required under Section 1129(a)(11)) or that there are certain events of default that are incapable of being cured. See In re Charter Communications, 419 B.R. 221 (Bankr. S.D.N.Y. 2009).

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