Seward & Kissel LLP

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Lessons from the LyondellBasell Rights Offering

A few years ago, rights offerings were a rarely employed means of financing an emergence from bankruptcy. However, a combination of the credit crunch and the increased entry of funds, more likely to take in equity from a borrower, into the loan market has resulted in the rise of rights offerings as a means for borrowers to raise capital to emerge from bankruptcy. Recently, many plans of reorganization have included some type of rights offering, replacing the more common issuance of bond debt. Despite criticisms that rights offerings are not a preferable means for a borrower that can utilize leverage to finance its emergence from bankruptcy, we can nonetheless expect to see more of them in the future. LyondellBasell Industries ("LyondellBasell"), Cooper-Standard Automotive Inc., GSI Group Inc. and Trident Resources Corp. represent just a few borrowers who have recently employed rights offerings to finance their emergence from bankruptcy.

This trend along with the rise of Collateralized Loan Obligations ("CLO") participation in the secondary market has given rise to a number of distinct settlement issues that can significantly delay settlements and possibly limit a buyer's ability to receive the entire package of benefits that might come out of a restructuring. These delays also increase counterparty risk and transaction costs and counterparties should take a strategic view when looking at credits with rights offerings. The settlement process in LyondellBasell provides a helpful illustration of a number of these issues.

LyondellBasell emerged from bankruptcy at the end of April following a 15 month restructuring. In connection with the restructuring, the company issued, among other things, Class A stock, which was issued as a direct proceed of the bankruptcy to senior secured claimholders in satisfaction of their claims. In addition, LyondellBasell decided to use a rights offering to finance its emergence, issuing approximately 263.9 million shares of Class B stock. Unlike the Class A stock, the rights offering for the Class B stock was voluntary. Therefore, a claimholder needed to directly subscribe for the shares, funding the purchase price at the time of subscription. Under the terms of the plan, only certain senior secured lenders were eligible to participate in the offering. As those lenders sold those rights in the secondary market, a problem emerged due to the participation of CLOs, causing loan market participants to rush settlement of outstanding loan trades with CLO counterparties, fearing that a CLO lender would not be able to purchase the Class B stock and deliver it downstream to buyers.

A CLO, though it may be able to hold stock, is often, by its nature and the terms of its organizational documents, prohibited from purchasing a defaulted asset, therefore barring its ability to participate in a rights offering. The issue generally centers on the CLO's ability to actually fund the stock purchase. A party with an outstanding loan purchase from a CLO, therefore, risked not receiving its ratable shares of Class B stock, and faced a reduced return on its purchase. In order for a buyer to guarantee receipt of Class B stock from a CLO, the parties had to settle the assignment of the loans before the record date for the rights offering, thereby earning the buyer record lender status to subscribe directly for the stock. Unfortunately, given the myriad of issues (ranging from a CAM exchange[1] to a high volume of open trades) obstructing trade settlement in Lyondell, many parties were left with open trades once the record date arrived. CLOs were thus forced to find ways to subscribe for and deliver the Class B stock. For open trades involving multiple parties where the CLO was not the record holder, multilateral nettings provided a simple solution. However, for CLOs that were the record lender, other solutions had to be found. A popular solution

[1] A CAM exchange, short for collateral allocation mechanism exchange, is a provision found in loan agreements to protect lenders in a bankruptcy by equalizing recovery across tranches covering multiple currencies or jurisdictions, by exchanging each lender's interest in one tranche for an investment in a strip across all tranches of the pool of debt.

that emerged was for the CLO lender to complete the subscription documents, but set up or designate a third party to receive the purchase funds from the CLO's buyer and then have the funds wired directly from the third party to the subscription agent. This required the subscribing CLO to clearly indicate to the agent on the subscription documents where the wire or wires, in the case of multiple counterparties, would be coming from. The clear risk was that the subscription agent might not be able to match the wire with the subscriber. If the subscription agent could not identify the relevant subscription funds, then the subscription faced rejection due to lack of funding and Class B stock would not be issued. This risk, however, for most parties was tolerable given the alternative of a CLO not subscribing at all.

Similarly, if a CLO was the purchaser in an unsettled loan trade, although the seller may have been able to subscribe, the CLO may not have been able to fund. In such cases, CLOs could set up third parties to hold the funds and wire them to the seller for payment of the subscription price. Since the plan required that the rights to participate in the offering travel with the loans, such that a seller could not agree to sell the subscription rights separately from the loans, parties were concerned about the implications of not transferring the Class B stock.

To address all these concerns, in addition to the standard loan documentation, parties in the loan market entered into side letter agreements to cover the rights and obligations associated with the subscription for and delivery of the Class B stock. In light of the above, for CLOs and their counterparties, it was essential to make clear how the rights offering would be handled, how the funds would be wired and adjust any representations and language to identify any third parties with obligations.

Given the rise in CLO participants in the loan market and the likelihood that more borrowers will employ rights offerings, loan market participants should be aware of their open trades and counterparty risk any time a borrower files for bankruptcy. CLOs especially should take heed and monitor their open trades for any credit for which a borrower is in bankruptcy. A CLO investor should consider multilateral nettings to avoid having to subscribe for or hold such stock altogether. In the event settlement on assignment or multilateral netting is not possible, CLOs, their investment managers and counsel should have alternate plans for settlement in place. Depending on the individual concerns and structural restrictions of a particular CLO, third party funding may be an option. If there are any impediments, CLOs should be sure to raise any alternate protective language at the time of trade and negotiate any alternative terms of settlement in the trade confirmation. Ultimately, CLOs should be aware of the impact a rights offering may have on their investment strategy and return when participating in the loan market.

This article recently appeared in Law360.

Philadelphia Newspapers

With the Philadelphia Newspapers decision, the Third Circuit became the second U.S. Court of Appeals to find that secured lenders do not have an absolute right to credit bid for their collateral when it is being sold under a chapter 11 plan of reorganization. As result, purchasers of secured debt will likely need to take additional measures to protect their right to credit bid for collateral to ensure that any sale of the collateral is for fair market value.

On March 22, 2010, the Third Circuit issued an opinion in the Philadelphia Newspapers bankruptcy case regarding secured lenders' right to credit bid for their collateral being sold pursuant to a chapter 11 plan of reorganization. The Court held that under the plain meaning of section 1129(b)(2)(A) of the Bankruptcy Code, Philadelphia Newspapers, LLC and its affiliates (the "Debtors") could advance a plan that allows for the sale of collateral and denies its secured lenders (the "Lenders") the right to credit bid for their collateral, provided that the plan conveys the "indubitable equivalent" of their allowed secured claim to the Lenders.

The Debtors filed a joint chapter 11 plan of reorganization (the "Plan") which provided for the sale of substantially all of the Debtors' assets. At the same time, the Debtors entered into an asset purchase agreement with a stalking horse bidder owned and controlled by the Debtors' former managers and certain insider equity holders. Shortly thereafter, the Debtors filed a motion for the approval of bidding procedures (the "Motion"), requiring any qualified bidder to pay the purchase price in cash, thereby precluding the Lenders from submitting a credit bid for the assets. The Lenders opposed the Motion on the ground that the plan was not "fair and equitable" because it denied them the right to credit bid.

The Third Circuit ruled that the "inclusion of the indubitable equivalence prong in section 1129(b)(2)(A) of the Bankruptcy Code intentionally left open the potential for other methods of conducting asset sales, so long as such methods sufficiently protected the secured creditor's interests."

The Court rested its holding upon the "unambiguous" language of section 1129(b)(2)(A) which indicates that a plan can be confirmed by satisfying any one of three enumerated methods in the Bankruptcy Code. The Court noted that section 1129(b)(2)(A) contemplates providing secured lenders with a fair and equitable recovery, but does not dictate the specific means of doing so, thereby allowing flexibility in crafting a plan. Accordingly, a secured lender's right to credit bid is not "absolute" when its collateral is sold pursuant to a chapter 11 plan of reorganization. The decision left open the possibility of the Lenders objecting at the plan confirmation hearing on the ground that they did not receive the fair market value for their collateral.

The Philadelphia Newspapers decision strongly favors debtors as well as inside purchasers of assets, and restricts a secured lender's ability to protect its interest in collateral. In light of this decision, secured lenders who provide post-petition financing to the debtor are likely to insist that both the financing order and the terms of the financing agreement preserve their right to credit bid for their collateral, whether pursuant to a sale under a plan or otherwise. A secured lender that has been denied the right to credit bid and still wishes to acquire its collateral will likely have to find creative ways of financing cash acquisitions, which may be particularly challenging when the debt is held by a syndicate of lenders. Moreover, potential bidders will likely be deterred from purchasing secured assets under a chapter 11 plan, as secured lenders who have been denied the right to credit bid will be more likely to object to plan confirmation and engage in lengthy litigation over actual fair market value of their collateral. Consequently, distressed debt traders will likely adjust the price and terms of secured debt to reflect these added risks and the new potential for delay in the plan confirmation process.

Recent Second and Seventh Circuit Decisions

Decisions from the Seventh and Second Circuits may bring relief to creditors who assigned their claims to trusts pursuant to chapter 11 reorganization plans. Bolstering the Second Circuit's reasoning, the Seventh Circuit recently held that a Chapter 11 trustee may have standing to bring suit on such creditors' behalf, thus providing creditors with an opportunity for greater recovery without incurring the significant time or expense of litigation.

The Seventh Circuit, in Grede v. The Bank of New York Mellon Corp., allowed the Chapter 11 trustee of a liquidation trust to bring suit on behalf of multiple, similarly situated creditors who assigned their claims to the trust pursuant to a chapter 11 plan. The court held that the liquidation trust was a "post-bankruptcy vehicle" and the trustee's ability to bring the lawsuit depended upon the terms of the confirmed chapter 11 plan, the trust instruments, and general corporate law, rather than the Bankruptcy Code. Importantly, the Seventh Circuit found that the U.S. Supreme Court's decision in Caplin v. Marine Midland Grace Trust Co. of N.Y. did not apply to such liquidation trusts or other "ex-debtors," and therefore did not preclude the trustee from suing on the claims assigned to the liquidation trust.

The Grede decision comes in the wake of an earlier decision by the Second Circuit which reached the same conclusion. In CBI Holding Co. v. Ernst & Young, the Second Circuit found that a disbursing agent of a chapter 11 plan had authority under the Bankruptcy Code to pursue fraud claims against the debtors' accountants which had been assigned by creditors pursuant to the chapter 11 plan.

The use of trust assets to pursue litigation on behalf of creditors with assigned claims may bring objections from creditors who have not assigned their claims. Such creditors may object to the use of trust assets to pursue litigation on claims that would not otherwise inure to their benefit. In these circumstances, the trustee may agree to an alternative payment method (such as a contingency fee or through distributions already earmarked for the assigning creditors) to satiate such objections.

Another possible concern is the assertion of a right of subrogation against the debtor, which could create a circular process that diminishes or eliminates any recovery by the trust on the assigned claims. However, a confirmed chapter 11 plan would presumably eliminate any right of subrogation against the debtor. Moreover, the trustee, as fiduciary, would still assess the costs and benefits of bringing suit on the assigned claims, and would only proceed if there was a net benefit to the assigning creditors.

As a result of these decisions, depending on the plan or reorganization, certain creditors in the Second and Seventh Circuits may have the cost of litigating assigned claims borne by the trust and shared amongst all other similarly situated creditors. While creditors who have not assigned their claims may take issue with this approach, it may afford creditors the opportunity to receive additional distributions in the event of successful litigation.

HEADS UP:

- The LSTA has issued a White Paper on CLOs, syndicated lending and the effects of the Dodd-Frank Bill, arguing that a decrease in the CLO market will severely hamper non-investment grade companies from obtaining enough capital for growth.

- The LSTA released new LSTA Trading Documents, including substantive revisions to the Purchase and Sale Agreement, and Proceeds Letter, which are effective for trades after August 6, 2010.

- **Recent Bankruptcy Filings:**
- RCLC Inc., filed 8/17/10
  - Case No. 10-35313-MBK
  - Bankruptcy Court: New Jersey, Trenton
- Apex Digital Inc., filed 8/17/10
  - Case No.10-44406-PC
  - Bankruptcy Court, Central District of California (Los Angeles)
- Boston Generating, LLC, filed 8/18/10
  - Case No. 10-14419-SCC
  - Bankruptcy Court, Southern District of New York
- Professional Veterinary Products Ltd., filed 8/20/10
  - Case No. 10-82436-TLS
  - Bankruptcy Court, District of Nebraska (Omaha)

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If you have any questions or comments about this Newsletter, please feel free to contact any of the attorneys in our Distressed Debt Group via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name followed by **@sewkis.com**.

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