**Rival Lender Groups Fight over the DIP Financing in the J.C. Penney Chapter 11**

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On March 17, 2020, in response to the COVID-19 pandemic to protect its customers and employees, J.C. Penney opted to close all of its stores and decrease supply chain operations.[1] Then, in mid-May, J.C. Penney and its affiliates (the debtors) filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of Texas, with a debtor-in-possession (DIP) loan and restructuring-support agreement (RSA) already in place with its first-lien lenders.[2] In a court filing, the chief financial officer stated that J.C. Penney's reorganization is "predicated on speed — it is not an option to languish in chapter 11" and that "nearly 85,000 associates are depending on" the company successfully reorganizing.[3]

J.C. Penney has stated it needs the DIP financing to reopen stores that have been closed due to government restrictions on nonessential shopping during the COVID-19 pandemic.[4] As of early June, J.C. Penney had 474 of its 846 stores open, while reopened store sales were down 26.9 percent for the month of May.[5] In contrast, e-commerce sales increased 15.7 percent for the month of May.[6] In June, as part of its "store optimization strategy," J.C. Penney permanently closed 154 stores.[7]

**J.C. Penney's Pre-Petition Secured Debt Capital Structure***

| Secured Debt (in U.S. $ millions) | Principal | First-Lien Group | Ad Hoc Crossholder Group |
|---|---|---|---|
| ABL Facility | 1,179 | | |
| First-Lien Term Loan | 1,521 | Holds ~ 73% of First-Lien Debt** | Holds ~ 16% of First-Lien Debt |
| First-Lien Notes | 500 | | |
| Second-Lien Notes | 400 | | |
| Total Secured Debt | $3,600M ($3.6B) | | |

* J.C. Penney Expert Report at 4; Kirkland Presentation June 4 at 6, 7.
** The first-lien debt is the total debt of the first-lien term loan and first-lien notes.

## Competing DIP Loan Proposals and RSA Terms

Leading up to the DIP loan hearing, competing DIP lender groups, the first-lien group and the *ad hoc* crossholder group, fought fiercely over which group the bankruptcy court should approve for DIP financing. The first-lien group included investors H/2 Capital Partners LLC and Silver Point Capital LP.[8] The crossholder group included investor Aurelius Capital Management LP.[9]

The first-lien group proposed DIP financing of $900 million, which included $450 million of new financing and a roll-up of the other $450 million.[10] The first-lien group's proposed DIP loan is self-priming, meaning that the loan would not be placing liens on collateral with pre-existing liens from other secured lenders.[11] In contrast, while the crossholder group's DIP loan proposal had a lower interest rate and fees and did not have a roll-up, the loan is not self-priming: It required a lien to be placed on collateral that secured the pre-petition asset-based loan facility (an "ABL facility").[12] Also, the crossholder group's proposal did not yet have a negotiated RSA or a business plan.[13]

The first-lien group's DIP loan provided J.C. Penney with $225 million to use immediately after the court approved the DIP loan and entered the DIP loan order.[14] The RSA included a "toggle event" on July 15, 2020, at which time the remaining $225 million of the DIP loan would be made available if 66.7 percent of the first-lien group approved J.C. Penney's business plan.[15] Also, the RSA has another "toggle event" on Aug. 15, 2020, which is a deadline requiring the company to obtain binding commitments for all third-party financing, on terms acceptable to the first-lien group.[16] If either of these events is not satisfied, then J.C. Penney is required to immediately toggle to a sale of all or substantially all of its assets under § 363 of the Bankruptcy Code.[17]

Per the RSA, as part of J.C. Penney's business plan, two new publicly traded entities would be created. J.C. Penney will spin off certain of its stores into a real estate investment trust (REIT), which would collect rent from these stores, and create a new operating company for J.C. Penney's business operations.[18] With the first-lien group's approval, J.C. Penney can sell up to 35 percent of the shares in the new REIT to fund its business. Also, under the RSA, J.C. Penney would sell its distribution centers.[19]

## Crossholder Group's Objection

In an objection filed on June 2 with the bankruptcy court, the crossholder group stated that the court and the debtors "should not be bullied into yielding to the threats of predatory lending terms that come at the expense of employees, customers, vendors and other creditors."[20] Moreover, the objection took issue with the onerous terms of the first-lien group's RSA, including the two toggle events on July 15 and August 15, which give the first-lien group the right to veto the business plan on either of those dates and toggle to a § 363 asset sale.[21] The crossholder group remarked that the first-lien group "threatened to use" their over 70 percent position in the first-lien debt to "force the debtors into liquidation if they don't get their way.[22]

The crossholder group's objection further alleged that the first-lien group's proposed DIP loan is an "impermissible *sub rosa* plan" that seeks to dictate the terms of a future reorganization plan before the bankruptcy court approves a disclosure statement and solicitation of votes for the plan to occur, which violates the protections provided to parties-in-interest under § 1125 of the Bankruptcy Code.[23] The objection further stated that according to the Fifth Circuit, a *sub rosa* plan is a transaction that has the "practical effect of dictating some of the terms of any future reorganization plan," and that courts also have held that *sub rosa* plans cannot be approved without satisfying the solicitation and confirmation requirements of the Bankruptcy Code.[24] The crossholder group's objection also alleged that the roll-up and cross-collateralization provisions of the first-lien group's DIP financing are inappropriate, the DIP loan fees "are beyond exorbitant," the case milestones are unreasonably short, and the crossholder group's DIP loan proposals are clearly superior to the first-lien group's proposed DIP loan.[25]

**Expert's Report**

In a court-filed declaration on June 2, an expert for the debtor stated that the first-lien group's proposed DIP loan is the product of an arm's-length negotiation process in good faith, is the best financing option available, and the terms are reasonable and appropriate under the circumstances.[26] The expert further stated that while the interest rate and fees of the crossholder group's DIP loan proposal were lower than the first-lien group's, the crossholder group's proposal "would require a protracted and costly priming fight" that the debtors might not win and would jeopardize the consensus reached with the first-lien group, which has a substantial majority of the debtors' first-lien debt.[27]

Thus, the expert explained, it would be very difficult to confirm a reorganization plan without the support of the first-lien group. The debtors would need to either raise sufficient cash to satisfy their claims in full, which would be difficult in the current financing environment, or raise sufficient debt to cram them down, which would leave the debtors highly leveraged after restructuring.[28]

**DIP Loan Hearing on June 4**

At the DIP loan hearing, the debtors' counsel, **Joshua A. Sussberg** (Kirkland & Ellis LLP; New York), stated before Hon. **David R. Jones** of the U.S. Bankruptcy Court for the Southern District of Texas that the crossholder group's DIP loan proposal was not actionable because the ABL facility lenders,[29] which included Wells Fargo, would not agree to allow their collateral to be primed, it jeopardized the consensus reached with 73 percent of the first-lien lenders, would lead to a lengthy and costly priming fight, and it jeopardized the company's only possible path to preserving 85,000 jobs.[30] At the hearing, the debtor's counsel also contended that the most favorable economic terms do not necessarily mean the best terms and that bankruptcy courts have approved less economically favorable DIP loans, because courts have deferred to the debtors' business judgment and the DIP loans had substantial support from first-lien pre-petition lenders.[31] At the hearing, an expert witness, on behalf of the debtors, testified that without new financing, J.C. Penney would run out of cash by the end of August.[32]

The debtors' counsel revealed to Judge Jones that the two competing lender groups had reached a settlement over the DIP financing.[33] Under the settlement agreement between the first-lien group and crossholder group, the crossholder group is allowed to participate in the DIP financing and will be able to convert $53 million of its debt claims into the post-petition DIP loan, meaning that the debt claims will have a higher priority of recovery in the chapter 11 case.[34]

**The Outcome**

After an extensive five-hour DIP loan hearing, weighing all of the preceding considerations as presented by the debtor's counsel and expert witnesses, Judge Jones, acknowledging the strict time constraints that J.C. Penney is under to reorganize as a viable business given its liquidity concerns and lack of a feasible alternative DIP loan proposal, stated that approving the DIP loan "is the only path forward that I see" and approved the first-lien group's DIP loan and RSA proposal as modified per the terms of the DIP loan settlement with the crossholder group.[35]

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[1] Kirkland & Ellis LLP Presentation, U.S. Bankruptcy Court for the Southern District of Texas, Case No. 20-20182 (May 16, 2020) (hereafter, "Kirkland Presentation May 16"), 45.

[2] *Id*. at 60.

[3] *In re J.C. Penney Co. Inc., et al.*, Chapter 11, Case 20-20182, Doc. 25, Declaration of Bill Wafford, Executive Vice President, Chief Financial Officer of J.C. Penney Co. Inc., in Support of Debtors' Chapter 11 Petitions and First-Day Motions (Bankr. S.D. Tex. May 15, 2020), 12.

[4] "J.C. Penney to Reduce Debt and Strengthen Financial Position Through Restructuring Support Agreement" News Release (May 15, 2020), 2.

[5] Kirkland & Ellis LLP Presentation, U.S. Bankruptcy Court for the Southern District of Texas, Case No. 20-20182 (June 11, 2020) (hereafter, "Kirkland Presentation June 11"), 3; Kirkland Presentation May 16 at 14.

[6] Kirkland Presentation June 11 at 3.

[7] "J.C. Penney Provides Update on Store Optimization Strategy," Press Release (June 4, 2020).

[8] Kirkland & Ellis LLP Presentation, U.S. Bankruptcy Court for the Southern District of Texas, Case No. 20-20182 (June 4, 2020) (hereafter, "Kirkland Presentation June 4"), 6.

[9] *Id*. at 7.

[10] *Id*. at 8.

[11] *In re J.C. Penney Co. Inc., et al.*, Chapter 11, Case 20-20182, Doc. 453, Declaration and Expert Report of David Kurtz in support of the Debtors' Motion for Entry of a Final Order Authorizing the Debtors to Obtain Post-Petition Financing Pursuant to Section 364 of the Bankruptcy Code (Bankr. S.D. Tex. June 2, 2020) (hereafter "J.C. Penney Expert Report"), 12.

[12] Kirkland Presentation June 4 at 9. The ABL facility was originally a senior secured asset-based revolving credit and term loan facility in a credit agreement, dated June 20, 2014, and subsequently, J.C. Penney prepaid and retired the term loan portion. J.C. Penney Co. Inc., Form 8-K, at 67 (of PDF), May 15, 2020; "JCPenney Announces Plans to Retire $500 Million Asset-Based Term Loan," News Release (Nov. 16, 2015). For additional information regarding the ABL Facility Loan, *see* exhibit on J.C. Penney's Pre-Petition Secured Debt Capital Structure in this article.

[13] Kirkland Presentation June 4 at 8, 13.

[14] *Id*. at 8.

[15] *Id.*

[16] Kirkland & Ellis LLP Presentation, U.S. Bankruptcy Court for the Southern District of Texas, Case No. 20-20182 (May 28, 2020), 16.

[17] *Id.*

[18] J.C. Penney Co. Inc., Restructuring Term Sheet (May 15, 2020), 2, 5.

[19] *Id*. at 3.

[20] *In re J.C. Penney Co. Inc., et al.*, Chapter 11, Objection of the *Ad Hoc* Crossholder Group to the 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, Case No. 20-20182, Doc. 469 [Relates to Docket No. 38], (Bankr. S.D. Tex. June 2, 2020), 8, 9.

[21] *Id*. at 8.

[22] *Id*. at 5.

[23] *Id*. at 26.

[24] *Id*. *See In re Braniff Airways Inc.*, 700 F.2d 935, 940 (5th Cir. 1983) ("The 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* in connection with a sale of assets.").

[25] *Id*. at 14, 20, 24, 27.

[26] J.C. Penney Expert Report at 1.

[27] *Id*. at 10.

[28] *Id*. at 13.

[29] *See* exhibit on J.C. Penney's Pre-Petition Secured Debt Capital Structure in this article.

[30] Kirkland Presentation June 4 at 9.

[31] *Id*. at 20. *See In re ION Media Networks Inc.*, 2009 WL 2902568 (Bankr. S.D.N.Y. 2009).

[32] Maria Halkias, "A Path Forward: J.C. Penney's Bankruptcy Judge Approves $900 Million Lifeline," *Dallas Morning News*, June 4, 2020.

[33] Kirkland Presentation June 4 at 16.

[34] *Id*.

[35] Halkias, *supra* n.32; Andrew Scurria, "Rival J.C. Penney Lenders Reach Bankruptcy Financing Deal," *Wall St. J.*, June 4, 2020.