AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Feature

By Douglas Mannal and Rachael L. Ringer

Avoiding Illusory Recoveries

Black-Scholes Protections for Warrants Issued under a Plan

Douglas Mannal
Kramer Levin Naftalis & Frankel LLP
New York

Rachael L. Ringer
Kramer Levin Naftalis & Frankel LLP
New York

Douglas Mannal is a partner and Rachael Ringer is an associate in the Corporate Restructuring and Bankruptcy Department of Kramer Levin Naftalis & Frankel LLP in New York.

The deep trough in the commodities market over recent years has resulted in a number of companies in commodity industries restructuring their balance sheets through a chapter 11 bankruptcy process. Because companies often reorganize in the midst of a market downturn, a commodity company's low earnings before interest, tax, depreciation and amortization (EBITDA) during this time often results in low values being placed on the company's reorganized equity at emergence. Low plan equity values make it difficult to provide junior creditors with significant recoveries on account of their claims, and senior creditors, who frequently accept the reorganized equity on account of their claims, end up being awarded a substantial amount of the reorganized equity of the debtor. Absent a negotiated resolution, junior creditors run the risk of receiving little to no recovery on account of their claims, only to have the commodity markets and the value of the reorganized equity recover post-bankruptcy. Under those circumstances, senior creditors receive a windfall at the expense of junior creditors.

Using Warrants to Bridge the Gap in Negotiations

When expected recoveries for junior creditors or other stakeholders are low, a company and/or its senior lenders may offer junior creditors — in an effort to gain their support for a reorganization process — consideration in the form of a relatively small percentage of equity in the reorganized company and/or warrants to purchase up to a certain percentage of equity in the reorganized company at a specified strike price for a period of time post-emergence. Because their value is primarily (if not solely) in the form of option value based on if and/or when the market recovers during the term of the warrant, warrants are often used as a tool to bridge the gap in negotiations between a debtor (or senior creditors) and junior creditors, as they allow junior creditors to participate in any upside but do not result in an immediate dilution of recoveries to senior creditors on the effective date.

When warrants are issued as consideration in a reorganization plan, they are usually given a strike price that puts them "out of the money" when the company emerges from bankruptcy (based on an implied enterprise value of the company upon emergence). However, because warrants are exercisable over a period of years (which can vary anywhere from three to 10 years, or more), they retain option value for the life of the warrant. The Black-Scholes model is the standard method that is generally used for valuing warrants.

To determine a warrant's option value, the Black-Scholes model uses inputs that include (1) the stock price at the time of valuation, (2) the strike price of the warrant, (3) the remaining term of the warrant, (4) the risk-free rate of return, and (5) the historical volatility of the common stock. A lower strike price, a longer term of the warrant and/or a higher volatility will generally yield a higher value. Conversely, a higher strike price, a shorter term and/or less volatility yields a lower value.

Black-Scholes Protections

Before agreeing to accept warrants as consideration for claims in a bankruptcy case, it is important to understand the risks that could be associated with those warrants. One obvious risk is that markets may not recover, so warrants might never come "into the money" prior to their expiration. Another important — but less obvious — risk that junior creditors must keep in mind is the potential for the reorganized company to enter into a transaction (*e.g.*, a sale, squeeze-out merger or other change of control) that could negatively impact or even eliminate the value of the warrants altogether.

For example, if a company has issued five-year warrants with a strike price of $1 billion, and in the second year post-bankruptcy it agrees to sell itself for consideration of $999 million, depending on the terms of the warrants, they could be determined to have only the value they would have if they were exercised immediately prior to the transaction. Since the transaction value is less than the strike price, the warrants could not be exercised, and would therefore have no value and might be canceled for no consideration. In such a circumstance, the value of the warrants may essentially be illusory, especially in an industry where there is anticipated consolidation. There are ways to protect against this second risk.

One way to protect the value of the warrants in such a transaction is to negotiate for "Black-Scholes protections" as part of the warrant package.[1] When a change-of-control transaction occurs post-bankruptcy during the life of the warrant, such Black-Scholes protections would require the reorganized company to measure the value of the warrants as of the transaction date using the Black-Scholes model, then pay the warrant-holders consideration of at least equal to the value of those warrants as part of the transaction.

While these Black-Scholes protections are not unprecedented, they are not as common as one would expect. In a handful of recent bankruptcy cases, creditors have negotiated for Black-Scholes protections for warrants under certain circumstances. For example, in *In re Sabine Oil & Gas Corp.*,[2] certain creditors who were being provided with warrants under the chapter 11 plan specifically negotiated for a "Black-Scholes cash out trigger" that provided for a valuation and cash-out of the warrant-holders upon certain triggering events, including the sale of all or substantially all of the company's assets or the sale of certain specified assets with an accompanying dividend.[3]

Other companies have similarly provided warrants with Black-Scholes protections under standard change-of-control transactions or a sale of substantially all of a company's assets (including, for example, *In re Autoseis Inc., et al.* and *In re Solutia Inc., et al.*[4]), while others have been limited to particular circumstances, including (1) a sale by the majority equityholder of more than 85 percent of its equity interests or a sale of 85 percent of the company's assets (*In re General Maritime Corp., et al.*[5]), or (2) a change-of-control transaction with an affiliate (*In re LyondellBasell Industries NV, et al.*[6]).

Modified Black-Scholes Protections

The preservation of value provided by Black-Scholes protections and their potential impacts on future transactions may create circumstances where the company and/or the senior creditors might be reluctant or unwilling to provide a warrant package with full Black-Scholes protections for the life of the warrant. The question then becomes, how do junior creditors protect the value of their warrants in a cash-out transaction?

One example of a negotiated resolution is embodied in the recent case of *In re Arch Coal Inc., et al.*[7] In January 2016, Arch Coal, a metallurgical and thermal coal mining company that was the second-largest holder of coal reserves in the U.S., filed for bankruptcy protection in the Eastern District of Missouri. At the outset of Arch Coal's bankruptcy cases, the company and its secured lenders contemplated a plan that offered second-lien and unsecured creditors (with more than $3 billion in claims) the option to receive a package of consideration consisting of 4 percent of the reorganized equity, and five-year warrants to purchase up to 8 percent of the equity in the reorganized company.[8] In addition, the proposed warrants were afforded no value protections in the event of a post-effective date transaction below the strike price.[9] On behalf of all unsecured creditors, the official committee rejected this proposal and proceeded to engage in investigations and negotiations with the company and an ad hoc group of its secured lenders for a package of consideration that provided sufficient value to unsecured creditors.[10]

These negotiations ultimately culminated in a substantially increased amount of consideration for unsecured creditors, consisting of $30 million in cash (some of which would be allocated to nonfunded-debt unsecured creditors), 6 percent of the equity in the reorganized company and seven-year warrants for up to 12 percent of the reorganized equity, with a strike price based on a $1.425 billion equity value.[11] In July 2016, at the time the deal was announced, the debtors estimated a going-concern enterprise value of between $650 million and $950 million and an estimated equity value of $324 million to $666 million.[12] Unsecured funded-debt creditors viewed the warrants as valuable and, given the speculated consolidation of the coal industry in the coming years, wanted to preserve that value in the event of a near-term transaction when the warrants were out of the money but still had significant option value.

Through negotiations, unsecured creditors were able to negotiate a unique Black-Scholes protection package that protected the value of the warrants in a squeeze-out transaction for five years of the warrants' seven-year term and capped the cash-out value of the warrants on the effective date, with a series of reductions in the capped value over time.[13] Specifically, the warrant package provided for Black-Scholes protection if any merger, recapitalization, business combination or other transaction that resulted in a change to the new common stock is consummated within the first five

1 The Black-Scholes protection is, in addition to other minority protections, negotiated as part of a warrant package.

2 No. 15-11835 (SCC) (Bankr. S.D.N.Y.).

3 *See* Memorandum Decision Confirming Debtors' Second Amended Joint Chapter 11 Plan of Reorganization at 63 (Aug. 18, 2016) (second-lien lender described Black-Scholes protections as "the most valuable protection [that] the Warrants have"); *see also* Hr'g Tr. 32:2-24 (June 21, 2016).

4 *In re Autoseis Inc.*, No. 14-20130 (Bankr. S.D. Tex. Dec. 2, 2014) [Dkt. 870] (Black-Scholes value paid upon change of control), and *In re Solutia Inc.*, No. 03-17949- SCC (Bankr. S.D.N.Y. Oct. 16, 2007) (Black-Scholes value paid upon sale, lease, transfer or other disposition of all or substantially all of company's property, assets or business).

5 *In re Gen. Mar. Corp.*, No. 11-15285(MG) (Bankr. S.D.N.Y. April 16, 2012) [Dkt. No. 744].

6 *In re LyondellBasell Indus. NV*, No. 09-10023 (CGM) (Bankr. S.D.N.Y. April 5, 2010) [Dkt. No. 4142].

7 No. 16-40120 (Bankr. E.D. Mo. 2016).

8 *See* Declaration of John T. Drexler in Support of Debtors' Chapter 11 Proceedings and First-Day Pleadings, Ex. A, *In re Arch Coal Inc.*, No. 16-40120 (Bankr. E.D. Mo. Jan. 11, 2016) [Dkt. 3]. The amount of equity and warrants distributed to such creditors (who were also required to give releases to certain parties, including the first-lien lenders) would be equal to the product of the proposed equity and warrants multiplied by the percentage of allowed second-lien and unsecured claims that elected to receive such package out of the total allowed second-lien and unsecured claims. *Id.* Creditors who did not elect to receive equity and warrants would receive the value of the company's unencumbered assets, if any, after all adequate-protection payments and all administrative and priority payments. *Id.*

9 *See id.*

10 Kramer Levin Naftalis & Frankel LLP served as counsel to the official committee of unsecured creditors in the *Arch Coal* bankruptcy cases.

11 *See* Order Authorizing the Debtors to Assume the Restructuring Support Agreement, Ex. A, *In re Arch Coal Inc.*, No. 16-40120 (Bankr. E.D. Mo. July 7, 2016) [Dkt. 1098].

12 *See* Solicitation Version of the Disclosure Statement for Debtors' Third Amended Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code, Appendix D, *In re Arch Coal Inc.*, No. 16-40120 (Bankr. E.D. Mo. July 8, 2016) [Dkt. 1101, Ex. A].

13 *See* Warrant Agreement, *In re Arch Coal Inc.*, No. 16-40120 (Bankr. E.D. Mo. Aug. 26, 2016) [Dkt. 1257, Ex. 3].

years post-emergence for consideration that is less than 90 percent of reporting stock (*i.e.*, more than 10 percent cash) for less than the strike price.[14]

In such a transaction, the warrant-holders would receive a payment capped at the lesser of (1) the Black-Scholes value (with a volatility input equal to the lesser of 50 percent and the 180-day historical volatility on Bloomberg), and (2) $45 million for the first year, $40 million for the second year, $35 million for the third year and $30 million for the fourth and fifth years post-emergence.[15] With this improved warrant package, more than 97 percent of the unsecured funded-debt creditors voted to accept the plan, which was confirmed by the bankruptcy court on Sept. 13, 2016.[16] Arch Coal emerged from bankruptcy as a public company on Oct. 5, 2016.

The Takeaway

Allowing junior creditors to participate in a market recovery through the use of long-term, out-of-the-money warrants has the potential to provide significant value for those creditors, but it is not without risk. To mitigate risk and preserve value for junior creditors, those creditors need to ensure that the warrant value is protected in the event of a squeeze-out merger or other similar transaction in which the minority shareholders are cashed out. In the event that the company or its senior lenders resist traditional Black-Scholes protections, an alternative structure (like that used in *Arch Coal*) presents a creative solution that can both foster consensus and maximize value for junior stakeholders. abi

Reprinted with permission from the ABI Journal, Vol. XXXVI, No. 2, February 2017.

The American Bankruptcy Institute is a multi-disciplinary, nonpartisan organization devoted to bankruptcy issues. ABI has more than 12,000 members, representing all facets of the insolvency field. For more information, visit abi.org.

14 *See generally, id.*

15 *Id.* The chapter 11 plan also provided an option for holders of funded-debt claims to elect to receive cash in lieu of warrants, which election would reduce the payments on a *pro rata* basis.

16 *See* Debtors' Memorandum of Law in Support of Confirmation of the Debtors' Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code and Omnibus Reply to Objections to Confirmation at 2, *In re Arch Coal Inc.*, No. 16-40120 (Bankr. E.D. Mo. Sept. 12, 2016) [Dkt. No. 1308].