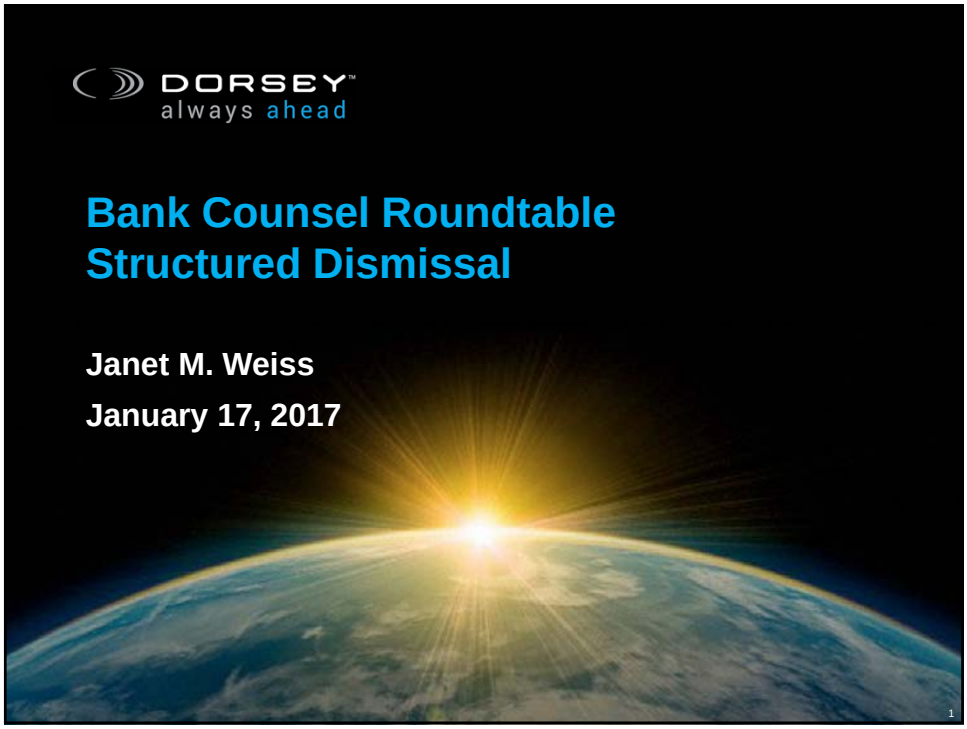
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Bank Counsel Roundtable
Structured Dismissal
Janet M. Weiss
January 17, 2017
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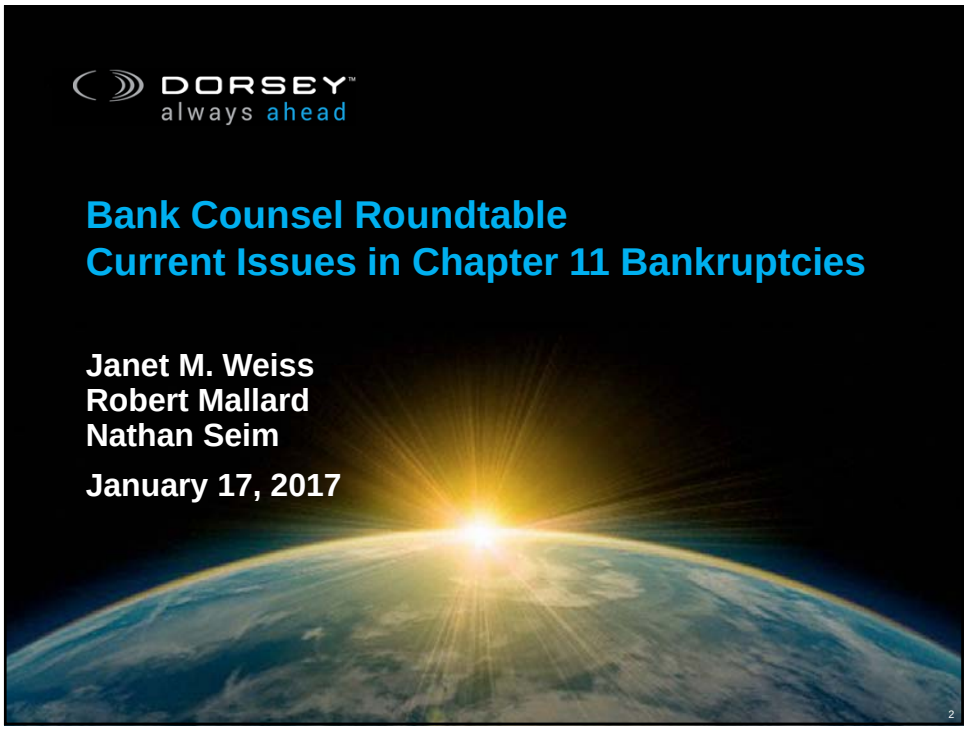
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Bank Counsel Roundtable
Current Issues in Chapter 11 Bankruptcies
Janet M. Weiss
Robert Mallard
Nathan Seim
January 17, 2017
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***Official Comm. Of Unsecured Creditors. V. CIT Group/Bus. Credit Inc. (In re Jevic Holding Corp.),* 787 F. 3d 173 (3d Cir. 2016),**
cert. granted* Casimir Czyzewski *v. Jevic Holding Corp., No. 15-649, 2016 WL 3496769 (U.S. 2016)

KEY DATES:

- *Cert. Petition Granted* – June 28, 2016
- *Argued – December 7, 2016*

ISSUE

- **Whether bankruptcy courts have authority to approve structured dismissals that deviate from the bankruptcy code priority scheme for distributing property**

HOLDING

- **The Third Circuit held that bankruptcy courts may, in rare instances, approve structured dismissals that do not strictly adhere to the bankruptcy code's priority scheme.**

Background

Claims Against Jevic/Debtor

- **$53 million secured claim to lenders, including Sun Capital;**
- **$12.4 million of truck driver WARN claims - $8.3 million priority claims ;**
- **$20 million of tax and unsecured creditors.**

Litigation Claims

- **Creditors' committee's claims for fraudulent transfer;**
- **Drivers' class action for WARN liability.**

Background cont'd

Proposed Settlement by Jevic (as Debtor), among

Unsecured Creditors' Committee and Sun Capital, as Senior Secured Lender

1. **Parties would exchange releases of claims against each other;**
2. **CIT would provide $2 million to pay Jevic's and the committee's legal fees and other administrative expenses.**
3. **Sun Capital would assign its lien on the remaining $1.7 million cash (after payment of senior, secured claims) to pay taxes and administrative claims.**
4. **Any remaining amounts would pay unsecured creditors.**
5. **Chapter 11 case is dismissed.**

Background cont'd

Truck Drivers' Claims and Treatment

Drivers were not given the opportunity to prove damages.

1. Drivers alleged $12.4 million damages.
2. $8.3 million of that amount alleged to be priority claims. (Courts have consistently held that Warn claims are "wages," and therefore receive the priority at 507(a)(4)).
3. **Jevic's CRO testified that because drivers were suing Jevic for fraudulent transfer, Sun Capital did not want drivers to receive funds that they could use to sue Sun Capital.**
4. **No other reason given for excluding drivers settlement.**

Third Circuit – Authority to Settle

- **The Bankruptcy Code does not expressly grant bankruptcy courts the power to approve settlements.**
- **The power to approve settlements derives from a Federal Rule of Bankruptcy Procedure promulgated by the U.S. Supreme Court – not Congress**

Bankruptcy Code Provisions Regarding Structured Settlements

- Section 349(b) provides effect of dismissal of a bankruptcy case.
- Dismissal usually returns the parties to the status quo.
- In a structured dismissal, the court approves the disposition of the debtor's money, pursuant to a settlement.
- Elements of structured dismissals may include, among other things:
  - Releases;
  - Determination and payment of claims; and
  - Gifting funds to unsecured creditors.

Objections

The drivers alleged that Jevic specifically excluded them from settlement, because paying their priority claims would leave nothing for the general unsecured creditors.

The US trustee and Drivers Asserted:

- settlement paid lower priority claims before higher priority claims;
- U.S. Trustee also objected on grounds that the bankruptcy code does not permit structure dismissals.
- Drivers also alleged breach of fiduciary duty by Board of Directors.

Bankruptcy Court Findings

Bankruptcy Court found that:

- **There was no prospect of a confirmable Chapter 11 plan or liquidation that provided distributions to any creditors other than senior secured lenders;**
- **Chapter 7 conversion not practical, because not sufficient funds to operate the business, investigate allegations, or litigate the issues;**
- **Drivers could pursue litigation against Jevic;**
- **Rejected drivers' argument that claims became worthless because the estate lacked unencumbered funds; and**
- **Found that dire circumstances justified approval of settlement and structured dismissal.**

Bankruptcy Court Decision

Bankruptcy court:

- **Overruled objections;**
- **Approved settlement and structured dismissal;**
- **Recognized that no authority in Bankruptcy Code for structured dismissals;**
- **Recognized precedent by the other courts that approved structured dismissals; and**
- **Found that settlement agreement need not comply with the Bankruptcy Code's priority scheme.**

Legal issues

Standard to Dismiss Bankruptcy Case

- **Section 1112(b)(1) of Bankruptcy Code provides that the bankruptcy court may dismiss the Chapter 11 case for cause.**
- **Section 1112 (b)(4)(A) provides the substantial or continuing loss to the estate in the absence of a reasonable likelihood of rehabilitation constitutes cause to dismiss a case.**

Standard for Court to Approve Settlement

There are four factors that guide bankruptcy courts to determine whether a settlement is fair and equitable:

1. **Probability success in litigation;**
2. **Likely difficulties of collection;**
3. **Complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and**
4. **Paramount interest of creditors.**

Settlements Must Be "Fair and Equitable"

Analyzed factors for approval of settlement:

- **Committee's chance of success on fraudulent transfer claim was "uncertain at best" given legal hurdles to recovery, substantial resources of CIT and Sun Capital and scarcity of committee' funds;**
- **Litigation was complex;**
- **New counsel could likely not be retained, because only source of payment was contingency fee; and**
- **Paramount interests of creditors weighed in favor of approval, because alternative to settlement was no distribution.**

Facts Of The Case Applied

Third Circuit refused to revise settlement to comply with the Bankruptcy Code priority scheme, because it accepted Bankruptcy Court's finding that there was no realistic prospect of the meaningful distribution to general unsecured creditors apart from the settlement.

Even though the truck drivers were excluded from settlement, despite having administrative priority claims, issue is whether the settlement serves the interests of the estate, not one particular group of creditors.

There was no support in the record that a viable alternative existed that would have better served the estate and the creditors as a whole.

Third Circuit Reasoning

- **Found some support for drivers' argument in *TMT Trailer Ferry*, where the Supreme Court held that requirement that plans of reorganization must be "fair and equitable" applies to compromises just as it does to plans of reorganizations. *Protective Comm. For Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968).**
- **But reasoned that case not dispositive because the issue in the case was confirmation of a plan – not approval of a settlement.**
- **Found that neither Congress nor Supreme Court has ever found that bankruptcy priority scheme applies to settlements.**

Third Circuit Reasoning

Third Circuit:

- **Reasoned that bankruptcy courts, like other courts, favor settlements.**
- **Noted that the drivers and U.S. trustee cited *Iridium* case approvingly.**
- **Reasoned that bankruptcy courts should have more flexibility in approving settlements than in confirming plans of reorganization.**

Third Circuit Reasoning – cont'd

- **Agreed that compliance with Bankruptcy Code priority scheme usually will be dispositive of whether a proposed settlement is "fair and equitable."**
- **However, held that courts could approve settlements that deviate from priority scheme if there are specific grounds to justify the deviation.**
- **Distribution to unsecured creditors, excluding the drivers, of the remaining cash in the trust was permissible despite deviating from the priority scheme, because without settlement, creditors overall would have a worse recovery.**

Third Circuit Holding

Third Circuit stated decision was a close call, but held that absent a showing that structured dismissal was contrived to evade the procedural protections of plan confirmation or conversion process, the bankruptcy court has discretion to order such a dismissal.

Case before court had no prospect for a confirmable plan, conversion to chapter 7 case provided no distribution to any creditors other than secured creditors, and left bankruptcy estate with complicated litigation claims.

Split in Circuits

Fifth Circuit in *AWECO* rejected settlement that did not comply with bankruptcy priority scheme, by distributing estate assets to unsecured creditors, despite the existence of unpaid senior claims. *In re AWECO*, 725 F. 2d 293, 295 – 96 (5th Cir. 1984)).

Second Circuit held that:

- Absolute priority rule not necessarily implicated in a settlement that is not part of a plan of reorganization. *In re Iridium Operating LLC*, 478 F. 3d 452 (5th Cir. 2007)
- Most important factor for approving settlement is whether it complies with Bankruptcy Code distribution scheme.
- But noncompliant settlement could be approved when remaining factors weigh heavily in favor of approving the settlement.

Second Circuit – cont'd

Proposed settlement deviated from Bankruptcy Code priorities in two respects:

- **First, by distributing estate assets to fund litigation against Motorola, despite non-payment of Motorola claim; and**
- **Second, by providing that any remaining money in litigation fund be distributed to unsecured creditors, but excluded Motorola from receiving any funds.**

Second Circuit – cont'd

First deviation (distributing assets to litigation fund against Motorola) was acceptable despite non-payment of Motorola because:

Debtor's settlement of lien validity litigation with the lenders reasonable, because litigation loss by Debtor would deplete estate of all remaining assets, and lenders would still have a lien over claims against Motorola.

Second deviation (distributing remaining funds in litigation trust to unsecured creditors) could not be justified, because no reason was articulated for deviating from bankruptcy priority scheme.

Second Circuit remanded to determine reason for second deviation from bankruptcy priority scheme.

Scirica, Concurrence

Reason settlement should not be approved is same as justification for not approving *sub rosa* plan – protections of plan process not available to creditors.

The settlement reallocates assets of the estate in a way that is not permissible in a plan of reorganization – it maximizes the return to some creditors at the expense of others.

Key question should be whether the deviation from the priority scheme was necessary to maximize the value of the estate.

ISSUES BEFORE SUPREME CIRCUIT

1. **Whether the Bankruptcy Code authorizes structured dismissals and**

2. **Whether Bankruptcy Court can approve settlement that violates bankruptcy code priority scheme by granting priority to a junior class**

Observations

- ***Jevic* decision changes negotiating leverage among debtor and creditors, particularly because the debtor has the sole ability to proposes settlement in structured dismissal;**
- **No finding that deviation from bankruptcy priority scheme is necessary to maximize the estate;**
- **Reason in *Jevic* case for deviation from bankruptcy priority scheme was desire by secured creditor to prevent funding of litigation trust against it; and**
- **Decision creates different standard for structured dismissal than for confirmation process.**

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Affiliate Setoffs and Netting Provisions

Robert W. Mallard, Partner Dorsey & Whitney, Wilmington, DE

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Basic Setoff Rule in Bankruptcy

- **Bankruptcy Code § 553:**

(a) "Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case … [IF]—"

- **The creditor holds a claim against the debtor that arose before the commencement of the case;**
- **The creditor owes a debt to the debtor that also arose before the commencement of the case;**
- **The claim and debt are mutual; and**
- **The claim and debt are each valid and enforceable**

Mutuality Requirement:

Debts are considered mutual when they are due to and from the same persons or entities in the same capacity

Triangular Setoff

- **Situation: A has a relationship with B (Debtor) and C, where B and C are affiliates or related parties.**
- **Triangular Setoff: A owes B (Debtor), and A attempts to set off such amount against amounts C (Affiliate of Debtor) owes to A.**
- **Triangular setoff is permissible under state contract or common law**
- **Permissibility under Bankruptcy Law very uncertain due to lack of mutuality**

Safe Harbor for Netting Agreements

- **Bankruptcy Code provides safe harbor designed to protect non-debtor parties to financial contracts when a counterparty files for bankruptcy**
- **Example is Bankruptcy Code § 561 which allows a non-debtor party to a master netting agreement to take immediate action to limit its exposure occasioned by a bankruptcy filing by or against the counterparty**

Safe Harbor Caution!!

- **Bankruptcy Courts in D. Del. and S.D.N.Y have held that contractual netting or other financial contracts with triangular setoff provisions not enforceable notwithstanding Safe Harbor:**
  - ***In re Semcrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009), aff'd 428 B.R. 590 (D. Del. 2010).**
  - ***In re Lehman Bros. Holdings Inc*., 433 B.R. 101 (Bankr. S.D.N.Y. 2010)**
  - ***In re Lehman Bros. Inc*. (Bankr. S.D.N.Y. Oct. 4, 2011).**
  - ***Sass v. Barclays Bank PLC (In re American Home Mortgage Holdings, Inc.)*, 501 B.R. 44 (Bankr. D. Del. 2013).**

Possible Solution to Triangular Setoff/Mutuality Problem

- **"a right to effect a setoff can never impose a "right to payment," it only can yield a right to pay less than one would otherwise have to pay." *In re Semcrude*, L.P., 399 B.R. 398.**
- **Guarantee of Debt – Guarantor is liable for making payment on debt it has guaranteed**
- **Affiliate Guarantees may create "mutuality" for purposes of § 553.**

Affiliate Guarantee

- ***Bloor v. Shapiro*, 32 B.R. 993 (S.D.N.Y. 1983). Guarantors of loans made by a lender-turned-debtor, to various entities owned by the guarantors, could assert setoff claims against the debtor on the basis that the guarantors assumed the entities' obligations to the debtor and the debtor had agreed that the guarantors were entitled to assert their debts as offsets against the debtor's claims. This gave rise to liability on the part of the debtor to the guarantors.**

- **A owes B (Debtor), and A wants to setoff such amount against amounts C (Affiliate of Debtor) owes to A.**
- **A should require B and C to guarantee their respective payment to A of their respective obligations.**
- **However the guarantees would be limited to the amount that B or C owes A as of the time when A exercises its rights under the guaranty**

Essential Elements to Give Rise to Mutuality	How is this Addressed Under the Proposed Structure
Affiliates must be liable for making payment on debts for which they have guaranteed payment	The guarantees would set up a situation where, if the Debtor (B) does not pay (A), the Affiliate(s) (C) will pay (A), but only to the extent the Affiliate (C) owes to (A) under the financial contract and is entitled to assert a setoff.
Affiliates (C) must have a right of collection against the Debtor (B)	Rights of collection limited to amounts the Affiliate (C) owes to owes to (A) under the financial contract
Debtor (B) and Affiliates (C) must consent to assertion of claims of (A) per their respective guarantees	Debtor (B) and Affiliates (C) acknowledge the guarantee and right of setoff

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Bank Counsel Roundtable
Make-Whole Provisions in Bankruptcy

Nathan S. Seim

January 17, 2017

Make-Whole Provisions

- **A make-whole is a type of call provision in a bond that allows the borrower to pay off remaining debt early. If the borrower pays the debt early, the borrower typically has to make a lump-sum payment to the bondholder pursuant to an agreed upon formula (generally based on net present value of future payments) to compensate the bondholder for the loss of income stream resulting from the early prepayment.**

In re MPM Silicones, LLC et al., 2014 WL 4436335 (Bankr. S.D.N.Y.)

Prior to the petition date, the Debtor issued Notes pursuant to an Indenture governed by New York law.

Section 3.03 of the Indenture (incorporating paragraph 5 of the Note) was entitled "Optional Redemption" and stated: "[P]rior to October 15, 2015, the [Debtor] may redeem the Notes at its option . . . at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium [the make-whole payment] and accrued and unpaid interest . . ."

Section 6.02 of the Indenture stated that if an Event of Default occurred as a result of the company filing for bankruptcy, "the principal of, premium, if any, and interest on all the Notes shall *ipso facto* become and be immediately due and payable . . ."

Section 6.02 also stated: "The Holders of a majority in principal amount of outstanding Notes . . . may rescind any such acceleration with respect to the Notes and its consequences."

In re MPM Silicones, LLC et al. CNTD.

The Debtor proposed a Chapter 11 plan, pursuant to which it would replace the Notes prior to their stated maturity, without paying the Applicable Premium [make-whole payment]. The Indenture Trustee objected to the proposed plan on the grounds that the Indenture required the Debtor to pay the make-whole payment.

The Bankruptcy Court began its analysis by stating the "well-known" law in New York that a lender forfeits the right to a prepayment premium if the lender accelerates the balance of the loan. Two exceptions to this rule:

- **When the debtor intentionally defaults to trigger acceleration and evade the prepayment premium; and**
- **When a clear and unambiguous clause calls for a prepayment premium or make-whole even in the event of acceleration.**

In re MPM Silicones, LLC et al. CNTD.

- **The Bankruptcy Court then looked at the Indenture under general rules of contract interpretation to see if the second exception applied, i.e., "whether the relevant sections of the Indenture and Notes provide with sufficient clarity for the payment of such premium after the maturity of the Notes has been accelerated."**
- **Again, Section 6.02 of the Indenture stated that if an Event of Default occurred as a result of the company filing bankruptcy, "the principal of, *premium, if any*, and interest on all the Notes shall *ipso facto* become and be immediately due and payable . . ." (emphasis added)**

In re MPM Silicones, LLC et al. CNTD.

- The Bankruptcy Court held: "[T]he references to other rights or 'premiums, if any' to be paid upon prepayment are not specific enough . . . to overcome the requirement of New York law . . . for a make-whole or prepayment claim to be payable post-acceleration."
- The Court further held that the automatic stay prevented the Indenture Trustee from rescinding the acceleration provision in the Indenture. Thus, the Court held the Debtor did not have to make the make-whole payment.
- The District Court affirmed the Bankruptcy Court, and this issue is presently before the Second Circuit.

In re Energy Future Holdings Corp. et al., 527 B.R. 178 (Bankr. D. Del.)

- In 2010, the Debtor issued $4 billion of Notes at a 10% interest rate due in 2020, secured by all the Debtor's assets.
- Section 3.07 of the Indenture (also governed by New York law) was entitled "Optional Redemption" and stated: "At any time prior to December 1, 2015 [the Debtor] may redeem all or part of the Notes at a redemption price equal to 100% of the principal amount of the Notes plus the Applicable Premium [the make-whole payment] . . . and accrued and unpaid interest."
- Section 6.02 of the Indenture contained an acceleration provision that made "all outstanding Notes . . . due and payable immediately" if EFHC filed for bankruptcy. There was no mention of the Applicable Premium, or any other premium that would be due on acceleration.
- Section 6.02 also gave the Noteholders the right to "rescind any acceleration [of] the Notes and its consequences."

In re Energy Future Holdings Corp. et al. CNTD.

- **Interest rates went down, and EFHC considered refinancing the Notes outside of bankruptcy, but that would have triggered the make-whole premium. By filing bankruptcy, the Debtor believed it could avoid paying the premium.**
- **Six months before it filed for bankruptcy, the Debtor filed an 8-K with the SEC and disclosed its strategy, whereby EFHC "would file for bankruptcy and refinance the Notes without paying any make-whole amount."**

In re Energy Future Holdings Corp. et al. CNTD.

- **After the Debtor filed bankruptcy, the Bankruptcy Court authorized the Debtor to refinance the Notes at a rate of 4.25%, which saved the Debtor over $13 million a month in interest.**
- **The Debtor did not compensate the bondholders for the make-whole payment, which would have been approximately $431 million.**
- **The Indenture Trustee filed an adversary proceeding against the Debtor, requesting a declaration that (1) the Debtor had to pay the make-whole premium; and/or (2) the Indenture Trustee could rescind the acceleration provision.**

In re Energy Future Holdings Corp. et al. CNTD.

- **Similar to the *MPM Silicones Court*, the Delaware Bankruptcy Court started with the premise that "under New York law, an indenture must contain express language requiring payment of a prepayment premium upon acceleration; otherwise it is not owed."**
- **The Court then focused on the automatic acceleration provision of Section 6.02 and held: "There is no reference in Section 6.02 to the payment of the Applicable Premium upon an automatic acceleration, nor is Section 3.07 [optional redemption] incorporated into Section 6.02. The parties included the concept of an Applicable Premium in only one instance (an optional redemption under Section 3.07). It is not mentioned in Section 6.02 or anywhere else in the Indenture."**

In re Energy Future Holdings Corp. et al. CNTD.

- **The Bankruptcy Court specifically noted that all parties to the Indenture were represented by sophisticated counsel, and had the parties wanted the make-whole provision to apply upon automatic acceleration of the Notes due to bankruptcy, they could have specifically said so.**
- **Thereafter, the Bankruptcy Court, via subsequent decision, also declined to lift the automatic stay to allow the Indenture Trustee to rescind the automatic acceleration of the Notes. The District Court affirmed the Bankruptcy Court.**

In re Energy Future Holdings Corp. et al., 842 F.3d 247 (3d Cir. 2016)

- **The Third Circuit took a different approach to interpreting the Indenture than the New York and Delaware Bankruptcy Courts. Rather than focusing on the acceleration provision of Section 6.02, the Court focused on the "Optional Redemption" provision of Section 3.07.**
- **Looking at the plain language of Section 3.07, the Third Circuit stated that the Debtor had a duty to pay the make-whole premium if (1) there was a redemption; (2) the redemption was voluntary; and (3) the redemption occurred prior to December 1, 2015.**

Third Circuit CNTD.

- **Was there a redemption—The Court held that unlike prepayments, redemptions can occur both pre- and post-maturity. Thus, even though the Debtor's bankruptcy accelerated the maturity of the Notes, the post-petition refinance was still a redemption.**
- **Was the redemption voluntary—The Court stated: "[The Debtor] filed for Chapter 11 protection voluntarily. Once there, it had the option . . . to reinstate the accelerated Notes' original maturity date. . . . A chapter 11 debtor that has the capacity to refinance secured debt on better terms . . . is in the same position within bankruptcy as it would be outside bankruptcy, and cannot reasonably assert that its repayment of debt is not voluntary."**
- **To close the loop, the Third Circuit recognized that the redemption occurred prior to December 1, 2015—the date set forth in the Indenture.**

Third Circuit CNTD.

- **Nothing in Section 6.02 negates the make-whole premium Section 3.07 requires if an optional redemption occurs before a stated date. Acceleration has no bearing on whether and when the make-whole payment is due.**
- **"If EFHC wanted its duty to pay the make-whole on optional redemption to terminate on acceleration of its debt, it needed to make clear that Section 6.02 [automatic acceleration upon bankruptcy] trumps Section 3.07 [optional redemption].**

Key Takeaways

- **It will be interesting to see what the Second Circuit does in the *MPM Silicones, LLC* case. Will it focus its analysis on the automatic acceleration provision (like the New York and Delaware Bankruptcy Courts), or will it focus on the Optional Redemption provision (like the Third Circuit)?**
- **Bankruptcy and appellate courts are deciding make-whole payment issues based on general contractual interpretation of the Indenture. As in all contract drafting, it is better to be specific and not assume anything.**