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Contributing Editor:
Jat Bains
Macfarlanes LLP

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Corporate Bankruptcy and Restructuring: 2021–2022


Joshua A. Feltman


Emil A. Kleinhaus


Michael S. Benn


John R. Sobolewski

Wachtell, Lipton, Rosen & Katz

While the COVID-19 pandemic continued into 2021, the sharp rise in corporate bankruptcies that we saw in 2020 did not. Due to unprecedented government assistance and the continued availability of credit at historically low interest rates, companies that survived 2020 were generally able to avoid Chapter 11 in 2021, even in industries significantly impacted by the pandemic.

The biggest storyline of 2021 was the use of Chapter 11 by companies facing large volumes of tort litigation. Although Chapter 11 has for decades been used as a tool to resolve mass tort situations, especially in asbestos-related cases, the range and scale of mass tort bankruptcies have expanded in recent years. This past year saw major cases involving opioids, talc and sexual abuse claims, among others. Although some of these cases remain unresolved or have appeals pending, several also passed key milestones over the past year, and the decisions that have been reached have given significant insight into both judicial decisionmaking in this space and the viability of Chapter 11 as a solution to different types of mass tort problems going forward. In 2022, we expect to see further legal developments in this area, as well as continued debate regarding the appropriateness, and viability, of bankruptcy as a solution to these problems.

We discuss below some of last year's trends and developments.

Chapter 11 Success Stories

In our 2021 chapter for *ICLG – Restructuring & Insolvency*, we noted that the COVID-19 pandemic, along with related oil market shocks and economic shutdowns, had caused a significant spike in corporate bankruptcies, including in the retail, travel and oil-and-gas industries. A year later, while certain industries are under pressure from the continuing impact of the virus and related restrictions, the experience of the pandemic has underscored that Chapter 11 is a potent tool to protect and revive fundamentally strong businesses that face unexpected headwinds or shocks.

In the early months of the pandemic, a series of major companies were forced to file for bankruptcy, including iconic retailers such as Neiman Marcus and JCPenney. Looking back, these and other cases were successful: the companies used Chapter 11 to obtain new financing, to make necessary adjustments to their business models (such as store closures for retailers), and to emerge from bankruptcy with less debt and new ownership.

Industries beyond retail also made successful use of Chapter 11. For example, CBL & Associates and Washington Prime Group – both REITS with large mall-based holdings – used Chapter 11 to deleverage their balance sheets, while Pennsylvania REIT employed it to extend maturities. Hertz also had a very successful Chapter 11 case; forced to file in May 2020 after a collapse in demand for rental cars, Hertz used the bankruptcy process to restructure its balance sheet and reduce its fleet of roughly 700,000 cars. The company emerged from bankruptcy a year later following a bidding war between creditor groups, and even Hertz's shareholders received a material recovery, a rarity in Chapter 11.

Mass Tort Bankruptcies

Many of the largest cases that were active in 2021 involved mass torts, including *Purdue Pharma* (opioids), *Mallinckrodt* (opioids), *Boy Scouts of America* (abuse claims), *Imerys Talc America* (talc), and Johnson & Johnson subsidiary *LTL Management* (talc).

As these cases show, Chapter 11 can be a powerful tool for companies inundated with tort lawsuits because it provides a forum in which to negotiate with claimants on a global basis and a mechanism to bind holdouts, enabling settlements that benefit all parties but might otherwise be unreachable. Bankruptcy may also be used to resolve, with finality, claims based on pre-bankruptcy conduct that might be asserted in the future, a form of protection not readily available under state law, allowing a true fresh start for companies that may otherwise face years, if not decades, of litigation.

At the same time, these cases have shown that bankruptcy is not a panacea. Mass tort debtors need broad claimant support to obtain finality, and voting-related challenges can delay or derail plan confirmation. Mass tort cases are also notoriously expensive and protracted, which can strain debtors whose businesses require a quick exit.

In 2021, courts grappled with important questions raised by the increasing use of bankruptcy to solve mass tort problems. Judicial decisions regarding two controversial issues in the mass tort world – the "Texas Two-Step" strategy and third-party releases of claims against non-debtors – are likely to have a significant impact on the future of mass tort bankruptcies.

The Texas Two-Step

In October 2021, Johnson & Johnson filed the *LTL Management* case, placing one of its subsidiaries in bankruptcy as part of a strategy designed to resolve its talc-related liability. This manoeuvre – the so-called "Texas Two-Step" strategy – has since been the subject of significant attention.

A Texas Two-Step takes advantage of a provision of Texas corporate law permitting "divisional mergers", which allow a company to divide itself into multiple entities and to allocate assets and liabilities between those entities. The Texas Two-Step strategy allocates the operating assets to one entity, while leaving the tort liabilities with the other. The entity with the tort liabilities then files for bankruptcy protection.

Some commentators have suggested that a Texas Two-Step could allow companies facing mass tort liabilities to strand those liabilities while the operating assets continue unimpaired. The reality has been more nuanced: in *LTL Management* and the other Texas Two-Step cases to date, the Chapter 11 debtor filed with the benefit of a "funding agreement" from the operating entity from which it was separated, through which the operating entity agreed to indemnify the debtor for its tort liabilities. As such, the Texas Two-Step has not been attempted as a means to shed liabilities altogether, but instead to leverage the benefits of the bankruptcy process for claim resolution without subjecting a healthy operating company (such as Johnson & Johnson's consumer products business) to the strictures of that process.

The Texas Two-Step strategy has garnered vociferous objections from the plaintiffs' bar, including because it is designed to stay large volumes of pending lawsuits while essentially replacing the plaintiffs' choice of forum (often state court) with a bankruptcy court. Indeed, the tort claimants in the *LTL Management* case sought to have that case dismissed as a "bad faith" bankruptcy filing. However, in a recent decision, the New Jersey Bankruptcy Court rejected the claimants' motion, concluding that a bankruptcy court is an appropriate forum in which to resolve mass tort claims and that employing the Texas Two-Step is not, on its face, disqualifying. Still, it remains to be seen whether the Texas Two-Step will garner widespread judicial acceptance now that it has a national audience – and, if so, what guardrails the courts or the United States Congress may impose to prevent any perceived abuses.

Non-Debtor Releases

The Chapter 11 process is of course designed to allow a debtor to discharge *its* liabilities; however, in many cases it has been used to obtain releases of claims against *non*-debtors as well. In asbestos-related cases, Section 524(g) of the Bankruptcy Code addresses that issue directly: it provides that, when 75% or more of affected claimants support a plan, the plan can channel certain tort claims related to a Chapter 11 debtor to a trust even if the claims are against a non-debtor third party, such as a shareholder or affiliate.

Outside the asbestos context, both the availability of non-debtor releases and the conditions under which they may be granted are subjects of intense dispute. Some courts (including three federal appellate courts) have held that non-consensual releases of non-debtors are not authorised by the Bankruptcy Code. Other courts (including the Third Circuit, which covers Delaware, and three other federal appellate courts) have indicated that such releases are permitted in certain circumstances, including where the released parties made major financial contributions, the releases have broad creditor support, and they are necessary to the success of the reorganisation.

This issue recently came to a head in the *Purdue Pharma* case, where the debtor negotiated a broad resolution with opioid claimants (including states and municipalities) that included a settlement with Purdue's shareholders, the Sackler family. In exchange for a $4.3 billion financial contribution, the Sackler family members bargained for broad releases of any opioid-related claims, including claims of states and municipalities that had sued them directly but would not consent to the releases. The bankruptcy court, after a trial, approved the plan and the releases. On appeal, however, District Judge McMahon of the Southern District of New York issued a lengthy decision concluding that the bankruptcy court lacked authority under the Bankruptcy Code to impose releases on non-debtors such as the states and municipalities that had sued the Sacklers directly.

Purdue Pharma is currently appealing the district court's decision to the Second Circuit, although mediation efforts following Judge McMahon's decision have already resulted in increased financial contributions from the Sackler family and a number of parties dropping their plan objections, which may alter the litigation outlook. Ultimately, the availability of non-debtor releases in bankruptcy may well be decided by the Supreme Court, whether in *Purdue Pharma* or a subsequent case. The ultimate result will have significant implications for mass tort (and other) Chapter 11 cases.

Make-Whole Premiums: An Important Result in *Mallinckrodt*

The *Mallinckrodt* case saw a notable development in the ongoing saga of the treatment of "make-whole" premiums in bankruptcy. In *Mallinckrodt*, the debtor sought to reinstate approximately $500 million in pre-petition secured notes – without paying a nearly $100 million make-whole premium that the noteholders claimed to be owed. The Bankruptcy Court, in early November, approved this reinstatement.

Make-wholes are a common feature of commercial lending arrangements. They are often calculated using a formula that discounts future interest payments using a treasury-based rate, and they are intended to ensure that lenders receive the benefit of their bargain, in terms of yield on capital, even if the borrower chooses to redeem the debt prior to maturity.

The Bankruptcy Code gives a debtor the power to reinstate the original maturities of debt obligations that were accelerated as a result of defaults, provided that defaults not based on the bankruptcy itself are cured. Once the obligations are reinstated, the debtor continues to meet its obligations as if there had been no bankruptcy. This ensures that debtors receive the benefit of any favourable financing that they may have secured prior to filing for bankruptcy, which helps maximise the value of the bankruptcy estate, on the condition that debtors continue providing their lenders with the benefit of their pre-filing bargain post-emergence.

Mallinckrodt's indenture provided that a make-whole premium would be payable in the case of an optional redemption. But it also provided that the make-whole would be "immediately" payable if the borrower filed a Chapter 11 case, an event of default under the indenture. The debtor argued that it could reinstate the debt without paying the make-whole because, among other reasons, the obligation had been accelerated solely as a result of the bankruptcy default. The noteholders argued that even though the reinstatement power permits principal and interest to be de-accelerated without regard to a bankruptcy default, that power does not extend to charges such as a make-whole premium.

The Delaware Bankruptcy Court agreed with the debtor, holding that the make-whole premium was a bankruptcy-accelerated obligation that could be reset through reinstatement. The decision, which is subject to appeal, is a welcome development for Chapter 11 debtors and unsecured creditors, as it provides a roadmap to reinstatement of secured debt without paying make-whole claims tied solely to the filing of bankruptcy.

The Return of Bankruptcy Appeals?

The doctrine of "equitable mootness" has frequently caused dismissal of appeals from confirmation orders where the plan has been consummated and undoing actions taken under the plan would be difficult. In recent years, this doctrine has come under scrutiny, as it has prevented significant issues of bankruptcy law from reaching appellate courts, leaving controversial rulings insulated from review. The Supreme Court has not yet weighed in on these issues.

In 2021, several high-profile cases focused attention on equitable mootness. In *Purdue Pharma*, for example, where the bankruptcy plan controversially contained non-consensual releases of non-debtors, the district judge made it clear that her review of the plan would not be frustrated by equitable mootness, and that she would consider staying the plan before it went effective if necessary to obviate the issue. In another case involving non-debtor releases, *Ascena*, the district judge hearing a bankruptcy appeal commented that "there's no way in the world I'm applying equitable mootness here".

Despite these examples of courts expressing concern about the effects of equitable mootness, the doctrine, if properly applied, serves an important function in ensuring that settled expectations regarding complex financial transactions are not disturbed after a plan has been consummated and investors have begun trading new securities. However, creditors must be aware that a reviewing court may resist equitable mootness where an appeal of a contested plan raises controversial legal issues, particularly if those issues can arguably be decided without affecting the core economics of a plan.

Joshua A. Feltman, in his cross-disciplinary practice, focuses both on acquisitions of leveraged entities in connection with in-court and out-of-court workouts and on the financing aspects of leveraged acquisitions generally, including negotiation, implementation and issuance of credit facilities and debt securities. Prior to joining Wachtell Lipton, Joshua worked as a consultant and economist on regulatory and antitrust matters for Price Waterhouse and National Economic Research Associates.

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
USA

Tel: +1 212 403 1109
Email: JAFeltman@wlrk.com
URL: www.wlrk.com

Emil A. Kleinhaus focuses on litigation and advisory work relating to bankruptcy, insolvency and creditors' rights. His areas of expertise include Chapter 11 reorganisations, fraudulent transfer and fiduciary claims, and disputes under credit agreements and indentures. In recent years, Emil served as co-chair of the Bankruptcy Litigation Committee of the Federal Bar Council and chair of the New York City Bar Association's Subcommittee on Fraudulent Conveyance Law.

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
USA

Tel: +1 212 403 1332
Email: EAKleinhaus@WLRK.com
URL: www.wlrk.com

Michael S. Benn represents borrowers with respect to all types of financing for mergers and acquisitions, spin-offs and other significant transactions across a wide variety of industries. In the distressed and restructuring space, Mike represents *ad hoc* lender groups and potential acquirors in connection with transactions in and out of bankruptcy.

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
USA

Tel: +1 212 403 1158
Email: MSBenn@wlrk.com
URL: www.wlrk.com

John R. Sobolewski's multidisciplinary practice includes a broad range of finance, restructuring and related matters, including leveraged M&A, private equity, public and private capital markets transactions, complex syndicated bank financings, special situations, in-court and out-of-court workouts, and debt default activism and net-short debt activism situations.

Wachtell, Lipton, Rosen & Katz
51 West 52nd Street
New York, NY 10019
USA

Tel: +1 212 403 1340
Email: JRSobolewski@wlrk.com
URL: www.wlrk.com

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