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# Restructuring & Insolvency

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# Corporate Bankruptcy and Restructuring: 2022–2023


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## Introduction

In 2022, mass torts and crypto dominated the bankruptcy scene. While Chapter 11 activity was otherwise relatively subdued, out-of-court restructurings accelerated as the year progressed, with companies turning to debt exchanges and other transactions to improve liquidity amidst challenging credit markets.

In 2023, rising interest rates, inflation and the possibility of a recession will present challenges for borrowers, sponsors and investors alike. Indeed, the year has started with marked distress among U.S. banks, with the failures of Silicon Valley Bank and Signature Bank and subsequent actions by the United States Treasury, Federal Reserve, and FDIC to help protect depositors and the banking system. The response of market participants to a high-interest rate environment not seen in more than 15 years – or, for many, in their professional lives – will be a storyline throughout 2023. We discuss below some of last year's trends and developments.

## Mass Tort Bankruptcies

Many of the largest Chapter 11 cases commencing or continuing in 2022 involved mass torts, including *Aearo Technologies* (combat earplugs), *Purdue Pharma* (opioids), *Boy Scouts of America* (abuse claims), and Johnson & Johnson subsidiary *LTL Management* (talc). Although some of these cases are unresolved or have appeals pending, significant judicial opinions in others have helped shed light on both the potential and limits of Chapter 11 as a solution to different types of mass tort issues.

As these cases show, Chapter 11 can be a powerful tool for companies beset by tort lawsuits, because it provides a forum in which to negotiate with claimants (including a representative for future claimants) on a global basis and a mechanism to bind holdouts. At the same time, recent and ongoing cases show that bankruptcy is *no panacea*. Mass tort debtors require broad claimant support to obtain finality, and the path to obtaining that support, where it exists, can be protracted and expensive.

In addition, even as more companies look to Chapter 11 to address otherwise intractable mass tort problems, courts have continued to grapple with fundamental issues presented by those cases. In particular, the recent opinion dismissing the *LTL Management* bankruptcy, discussed below, has called into question the viability of the Texas Two-Step strategy.

### Non-debtor releases

The Chapter 11 process is principally designed to allow the debtor to obtain a fresh start free of its own past liabilities. But in many cases, it has also been used to resolve the related liabilities of non-debtors. In asbestos-related cases, the Bankruptcy Code addresses that issue explicitly: when 75% or more of affected claimants support a plan, the plan can channel asbestos claims related to a Chapter 11 debtor to a trust, even if the claims are (or would be) asserted against certain non-debtor affiliates.

Outside the asbestos context, where the statute is not so explicit, non-debtor releases remain the subject of intense dispute. Some courts have held that non-consensual releases of non-debtors are simply unauthorised. Other courts have permitted them in limited circumstances, including where the releases have broad creditor support and the released parties make major financial contributions in fund payments to tort claimants. In 2022, in the landmark *Boy Scouts of America* case, the Bankruptcy Court in Delaware approved a broadly supported Chapter 11 plan to resolve claims not only against the debtor but also against affiliated local councils and others that made significant financial contributions to a global settlement. The decision is on appeal.

The legality of non-debtor releases is also at issue in *Purdue Pharma*. In that case, the debtor negotiated a resolution with opioid claimants that included a broad release of claims against Purdue's shareholders, the Sackler family. The bankruptcy court approved the plan, including the Sackler releases. On appeal, however, the Southern District of New York issued a lengthy decision reversing the bankruptcy court and disapproving the nonconsensual releases. Purdue's further appeal to the Second Circuit Court of Appeals remains pending (congressional interest in legislation curbing the use of non-debtor releases, which in 2021 prompted hearings concerning Purdue and other cases, for now seems to have abated).

Separate and apart from the issue of non-debtor releases as part of a plan, courts have also struggled with requests by debtors to enjoin lawsuits against related non-debtor parties while the bankruptcy case is pending. There is significant precedent for such injunctions in cases where, among other things, the related party has indemnity rights against the debtor or shared assets such as joint insurance. In the *Aearo Technologies* case, however, an Indiana bankruptcy court denied an injunction request filed by a 3M debtor-subsidiary to enjoin prosecution of thousands of earplug-related suits against 3M. That decision is on appeal.

### The so-called "Texas two-step"

The *LTL Management* case, through which Johnson & Johnson (J&J) sought to resolve its talc-related liability, has drawn nationwide attention to the so-called "Texas Two-Step" strategy (given that label's wide adoption, it is used for convenience without any connotation).

A Texas Two-Step uses 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 allocates operating assets to one entity, while leaving the tort liabilities with the other. The entity with the tort liabilities then files for bankruptcy protection.

Companies have not, to date, attempted to use the Texas Two-Step to try to strand liabilities at a new company without assets to service the liabilities. Instead, in the *LTL Management* and the other Texas Two-Step cases, the Chapter 11 debtor has filed with the benefit of a "funding agreement" with the separate operating entity, through which the operating entity agreed to indemnify the debtor for its tort liabilities.

In the *LTL Management* case, claimant representatives sought to dismiss the Chapter 11 case as having been filed in "bad faith". They argued that the Texas Two-Step was an abuse of the bankruptcy process insofar as it allowed J&J's consumer business to address its liabilities in Chapter 11 without exposing all of its assets and ongoing business to court supervision, and insofar as it allowed a solvent business to avoid the tort system with respect to thousands of pending suits.

In a ruling issued January 30, 2023, the Third Circuit Court of Appeals (which covers Delaware) sided with claimant representatives and directed dismissal of the Chapter 11 case. In doing so, the Court relied on the requirement in its case law that the debtor must be in "financial distress" before availing itself of bankruptcy protection, and concluded that LTL could not meet that requirement, in large part due to its access to approximately $61 billion under a funding agreement backstopped by the J&J parent. Although the Third Circuit expressly declined to decide whether the Texas Two-Step might remain viable in other contexts – and appeals of the Third Circuit decision remain pending – solvent corporations seeking to use Chapter 11 to address their mass tort liabilities will need to strategise accordingly.

The attractions of using Chapter 11 to resolve business mass tort problems, and the controversies over non-debtor releases, the Texas Two-Step and other distinct features of mass tort bankruptcies, will no doubt continue to be a theme in 2023.

## The Crypto Crash

The "crypto winter" that began with the collapse of so-called "stablecoin" Terra in spring 2022 led to a deluge of crypto-related Chapter 11 filings. Over the last months, crypto players, including Celsius, BlockFi, Core Scientific, Genesis, Voyager, and, most prominently, FTX/Alameda, have all sought Chapter 11 relief. While the reasons for each crypto bankruptcy vary, the cases have presented novel questions of how Chapter 11 and its tools can – and whether they should – be applied to crypto-related businesses.

Since its inception, the cryptocurrency industry has largely functioned as an alternative financial ecosystem. Although predicated on a sweeping vision of decentralised finance, as the industry has grown, centralised crypto analogs for banks, brokerages and exchanges have all developed, but without comprehensive regulatory oversight. Of particular consequence, while there are well-established statutory regimes for liquidations of failed securities or commodities brokers (which are not eligible to be debtors under Chapter 11), there is no special state or federal legal procedure designed for a liquidation of a crypto company. Customers of centralised retail-oriented crypto-asset platforms also lack protections analogous to FDIC or SIPC insurance. Bankruptcy courts in crypto cases have thus found themselves with a lack of statutory guidance or judicial precedent to answer fundamental questions.

As a result, the crypto cases have been freewheeling. Unlike traditional bank and brokerage failure regimes, which require mandatory liquidation by an independent trustee or receiver, leaders of crypto enterprises have sought other outcomes, such as intact sales to other crypto companies. Bankruptcy courts have also been required to make rulings on whether crypto deposited by customers with crypto brokerages is the customers' property and thus should be returned to those customers, or whether it is instead "property of the estate" created by the bankruptcy filing, leaving customers with general unsecured claims. In *Celsius*, the bankruptcy court held that most of the crypto deposited with Celsius was "property of the estate".

There are also open questions as to whether some crypto companies are even eligible for Chapter 11. The SEC and CFTC have alleged that several crypto players were in the business of brokering the sale of commodities or of unregistered securities. If adopted, such a characterisation may imply that those businesses ought to be treated as stockbrokers or commodities brokers, potentially rendering them ineligible for Chapter 11 reorganisation.

These are just a few of the issues that have arisen. In the long run, we believe the recent crypto collapses may well increase momentum for a broader body of regulation for the crypto space, including a regime for failed crypto companies.

## Liability Management Activity

In 2022, borrowers and creditors continued to work together to raise capital and manage liabilities outside of bankruptcy court. Some "liability management" transactions, including "uptier" transactions, have spawned litigation. But in spite of those disputes, the pace of such transactions has, if anything, continued to accelerate.

Historically, members of each distinct class of creditors in a distressed situation tended to work together to defend their collective interests relative to other classes. But high-profile liability management transactions in recent years have altered that dynamic. Today, informal subsets of debt-holders within a class often propose transactions that are not open to all creditors in their class, and in some cases offer those participating creditors a financial edge over those who do not participate.

One prominent form of this new wave of transactions is a "drop-down" transaction, in which a borrower uses flexibility within its debt documents to contribute assets to an "unrestricted subsidiary" not subject to existing liens or covenants. The unrestricted subsidiary then borrows from existing or new creditors and pledges the newly unencumbered assets. This type of transaction is sometimes coupled with an exchange offer where participating lenders are offered the opportunity to exchange existing debt for new debt at the unrestricted subsidiary, typically at a discount.

Another new form is an "uptier" transaction, where a subset of a company's existing lenders and the company amend the company's existing debt documents to permit the transaction, including by allowing existing liens to be subordinated to new debt, after which the participating lenders exchange their debt (again, typically at a discount) for new debt that is senior to the unexchanged debt held by others. This type of transaction is often coupled with new money financing provided by the participating lenders on a "superpriority" basis.

Some of these transactions have resulted in litigation. In *TPC Group*, a Delaware bankruptcy judge recently upheld a variant of an uptier transaction, holding that the loan documents permitted the company and the majority lenders to subordinate existing liens to permit new-money superpriority financing. On the other hand, in *Boardriders*, a trial judge in the New York Commercial Division declined to dismiss a complaint challenging an uptier transaction, including on the basis that it allegedly violated an implied covenant of good faith and fair dealing. An appeal of *Boardriders* remains pending. Litigation in other "uptier" cases is also pending.

For borrowers facing financial challenges, these types of transactions can be effective tools to generate liquidity or to deleverage. As a result, the specific terms of the debt documents that relate to such transactions have become more critical than ever, and should be carefully reviewed by borrowers and lenders alike to understand the full menu of options that might be available. Lenders should be active, constructive and open-minded. For lenders, being a first mover, with a willingness to provide capital and to think creatively, may well be rewarded.

## Developments in Allowance of Make-Wholes and Post-Petition Interest

Bankruptcy practitioners and debt investors alike are familiar with the Bankruptcy Code rule that holders of unsecured claims cannot receive "unmatured interest", meaning that interest on unsecured debt stops accruing on the petition date. In high-profile cases decided in 2022, federal courts of appeals considered aspects of this rule, including whether it applies to payment of a "make-whole" premium (a payment owed by the borrower when the borrower repays debt prior to maturity) and whether an exception exists in the rare cases where the debtor is solvent.

In *Ultra Petroleum*, the debtor became "massively solvent" due to a sharp increase in natural gas prices while its case was pending. Unsecured bondholders sought payment of a make-whole premium and post-petition interest, arguing that the make-whole was a form of liquidated damages rather than unmatured interest, and that, in any event, a "solvent debtor exception" required payment of unmatured interest.

The Court of Appeals for the Fifth Circuit (which covers Texas) agreed with the unsecured bondholders, but only because of a "solvent debtor exception". The court held that unsecured make-wholes should generally be disallowed as unmatured interest, given the economic reality that they are designed to approximate lost future interest. Nonetheless, the court agreed that solvent debtors must pay unmatured interest, and therefore awarded both post-petition interest and the make-whole. The significant implication, however, is that – in much more common cases involving insolvent debtors – unsecured creditors' make-whole claims will be disallowed, at least in the Fifth Circuit.

The *Ultra* court also considered what interest rate is to be paid by solvent debtors after the petition date and concluded that the contract rate, rather than the (much lower) rate applicable to court judgments, was appropriate. Earlier in 2022, the Ninth Circuit, which covers an area including California, reached substantially the same conclusion in PG&E, holding that the debtor, which was undisputedly solvent but had filed bankruptcy to address wildfire tort liabilities, had to pay post-petition interest to its unsecured creditors. Other courts, however, including the Delaware bankruptcy court in *Hertz*, have concluded that the federal judgment rate is the appropriate metric for a solvent debtor. An appeal of *Hertz* on this point remains pending.

Solvent debtors are the rare exception in Chapter 11, but as shown by cases such as *Ultra* and *PG&E*, they increasingly are seeking to take advantage of the Bankruptcy Code to address particular problems. The recent decisions discussed above show that courts, while allowing solvent debtors to use the tools of bankruptcy in some cases, have insisted that those debtors pay all contractual amounts owed to creditors, even if such amounts would not be payable by insolvent debtors.

## Other Developments

Below are other developments we have observed in early 2023 and expect to continue throughout the year:

- *All eyes on reinstatement.* The rapid rise in interest rates has rendered the terms of many fixed-rated instruments well below-market. We expect Chapter 11 debtors to be increasingly tempted to seek to reinstate those agreements under sectionc1124 of the Bankruptcy Code. In the *Mallinckrodt* case, as an example, the debtors successfully reinstated their first-lien notes, defeating an argument for immediate payment of a make-whole premium triggered by the bankruptcy filing. An appeal of that ruling remains pending. Participants in the Chapter 11 process would be well-served to evaluate the opportunity for (in the case of debtors) and risk of (in the case of investors) reinstatement of company-favorable financing arrangements.
- *Rise of cooperation agreements?* Partially as a reaction to recent liability management transactions, in several recent situations, creditors have banded together and signed cooperation agreements whereby they agreed not to support a transaction with the borrower unless it met certain agreed procedural criteria (usually, that the transaction be agreed to by some majority of the group, and that it be offered to all group members on substantially the same terms). As liability management activity continues, we may see more of such agreements.
- *Return of retail bankruptcies.* Over the past two years, retail bankruptcies have been relatively few and far between, following a dramatic surge in the early days of the COVID-19 pandemic. However, the combined factors of consumers under pressure from inflation, retailers being overextended on inventory, and capital markets having significantly tightened, has dampened the outlook for stressed retailers. The early portion of 2023 has already seen several retailers file, including *Party City* and *Tuesday Morning*, with Bed, Bath and Beyond narrowly dodging its own filing. These early filings may indicate a broader uptick in retail Chapter 11 cases in 2023.
- *Pressure on the banking system?* March 2023 saw two of the largest banking failures in United States history, with regulators stepping in to shut down both Silicon Valley Bank and Signature Bank. Though regulatory authorities took significant steps in the ensuing days to shore up the stability of the banking system, it remains to be seen whether these bank failures will prove to be a pair of anomalous results, or early warning signs of broader instability in the sector resulting from the rapid rise of interest rates over the last year.

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