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Corporate Bankruptcy and Restructuring: 2016/2017

Last year was an active but uneven one in the world of corporate bankruptcy and restructuring. On the one hand, default rates in the U.S. remained at relatively muted levels, with the continuation of low interest rates and strong (if sometimes volatile) capital markets. At the same time, as we anticipated a year ago, 2016 was also marked by distress among oil-and-gas exploration companies, "brick and mortar" retailers and municipal issuers in Puerto Rico.

Although commodity prices have stabilized, we expect companies in the oil and gas sector to face continued pressure in 2017. The pressure on traditional retailers, including from on-line shopping, will likewise persist. And in Puerto Rico, which has elected a new government and become subject to a newly created federal oversight board, negotiations with creditors will likely accelerate.

On a "macro" level, recent statements from the Federal Reserve regarding monetary policy, combined with statements from the President-elect regarding fiscal stimulus, have led to predictions of higher interest rates. Higher interest rates could have a substantial effect on borrowers, both in the U.S. and abroad, seeking to refinance their debt. Importantly, however, the full effect of any rate increases may be postponed: As a result of the enormous wave of high-yield refinancings between 2011 through 2014, non-investment grade maturities have in many cases already been deferred past 2017.

We discuss below several important developments and themes from 2016, as well as expectations for 2017.

Out-of-Court Restructurings and the Trust Indenture Act

In May 2016, the Court of Appeals for the Second Circuit heard oral argument in *Marblegate Asset Management* v. *Education Management Corp.* As we wrote last year, at issue in *Marblegate* is whether an out-of-court debt restructuring — which does not amend the indenture's payment terms, but which purportedly curtails a noteholder's practical ability to collect payment — violates section 316(b) of the Trust Indenture Act (TIA). Section 316(b) of the TIA protects a noteholder's "right to receive payment" when due from being "impaired or affected" without consent. The provision has traditionally been understood to prohibit amendments to an indenture, by majority vote, that alter the amount owed or the due dates for payment. However, several district courts (in *Marblegate* and subsequently in decisions involving Caesars Entertainment Corp.) have held that

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"out-of-court restructurings" that affect a noteholder's practical ability to collect payment may run afoul of the TIA.

Following the *Marblegate* and *Caesars* decisions, noteholders have brought lawsuits invoking the TIA to challenge out-of-court transactions, including relatively standard debt exchanges. In December 2016, in *Waxman* v. *Cliffs Natural Resources*, a class action challenging an exchange of new secured debt for outstanding unsecured notes, a district court rejected the argument that the transaction violated the TIA by effectively subordinating the notes of holders who were not eligible for the exchange. Without agreeing or disagreeing with *Marblegate* and *Caesars*, the court concluded that the exchange did not violate the TIA because it did not have characteristics of an "out-of-court restructuring."

Overall, the district court decisions in *Marblegate* and *Caesars* have introduced a litigation risk that must be considered in designing debt transactions. The timing of the Second Circuit's decision in *Marblegate* cannot be predicted, but it is likely to provide guidance for parties in structuring future transactions.

<u>The Energy Sector: Exchanges, Pre-Packaged Plans and Gathering Agreements</u>

Over 60 oil and gas producers filed for bankruptcy in 2016, representing more than $50 billion in funded debt. There were also numerous chapter 11 filings of businesses that are dependent on oil and gas producers, such as oil-field servicers and helicopter providers.

At the same time, with commodities prices stabilizing, numerous energy producers were able to manage their liabilities without resort to any proceeding. In particular, companies including Cliffs Natural Resources (discussed above), Vanguard Natural Resources and Chesapeake Energy undertook exchanges of new secured debt for outstanding unsecured notes. Those transactions allowed the issuers to capture discount associated with below-par trading prices while extending debt maturities.

Other companies in the sector, although unable to avoid bankruptcy, achieved efficient debt restructurings in chapter 11. For example, Key Energy reached agreement with its term loan creditors and many senior noteholders on a pre-packaged bankruptcy plan that was completed within two months. Atlas Resource Partners (now Titan Energy) and Halcón Resources also emerged from bankruptcy in under two months with confirmed plans. Given the cost and uncertainty of traditional "free fall" chapter 11 cases, we expect oil-and-gas companies with too much leverage to continue pursuing out-of-court solutions and, if necessary, pre-negotiated chapter 11 plans.

Another significant development for oil and gas companies came in a decision issued by the bankruptcy court in New York in the Sabine Oil & Gas case. The case addressed whether "gathering agreements," in which a producer dedicates oil and gas produced from a specific area to a particular operator, are eligible to be "rejected" by producer-debtors in bankruptcy. These dedications have traditionally been viewed as covenants running with the land, with the effect that they could not be rejected. In *Sabine*, however, the court approved a debtor's rejection of gathering agreements with pipeline operators, holding that the dedications were not covenants that "run with the land" under Texas law. Following *Sabine*, distressed producers have gained bargaining power over pipeline operators; operators in turn have sought additional credit support from producers. It would not be surprising if this issue is addressed further in a Texas venue.

Redemption Premiums

Over the last several years, there has been substantial litigation regarding "make whole" premiums in bankruptcy. A major point of dispute relates to whether premiums that would be payable outside of bankruptcy in the event of an early repayment are payable when, under the governing loan documents, the debt maturities have been accelerated (often automatically) due to a bankruptcy filing. In November, we wrote about the Third Circuit's decision in *EFH*, which held that the debtors were required to pay a make whole premium — due under the governing indenture in the context of a voluntary "redemption" — when the debtors opted to refinance their notes post-filing with lower-cost paper. The court distinguished between "redemptions," which can occur either before or after maturity, and "prepayments," which by definition occur before maturity, and concluded that a premium due upon "redemption" was still payable following the automatic acceleration of maturities in a bankruptcy.

The *EFH* decision will likely affect future cases, particularly in Delaware, by providing secured lenders with greater leverage and debtors with less flexibility in refinancing secured debt. The decision also provides guidance to loan parties in drafting clearer make-whole provisions that will lead to more certain outcomes. Following *EFH*, borrowers are on notice that they will likely need to pay make-whole premiums in bankruptcy unless they negotiate for clear language stating that *no* premium is due following a bankruptcy-induced acceleration.

Bankruptcy Code "Safe Harbors"

Sections 546(e)-(g) of the Bankruptcy Code, which are among the Bankruptcy Code's "safe harbor" provisions, protect payments made in connection

with securities contracts, swap agreements, repurchase agreements and certain other types of financial market transactions from fraudulent transfer challenge in the absence of intentionally fraudulent conduct.

In 2016, federal appellate courts issued two important decisions regarding the scope of the Bankruptcy Code's "safe harbor" provisions. As discussed in our prior memo, in March 2016, the Second Circuit reversed the district court in *Tribune*, holding that the safe harbors protect covered transactions not only from fraudulent transfer claims brought by the bankrupt estate, but also from claims brought by individual creditors following a bankruptcy under state fraudulent transfer laws. Accordingly, in the Second Circuit, the *Tribune* decision will prevent bankrupt debtors from circumventing the safe harbors by abandoning estate causes of action to creditors.

In July 2016, in *FTI Consulting, Inc.* v. *Merit Management Group*, the Seventh Circuit addressed the scope of section 546(e), which protects pre-bankruptcy settlement payments "made by or to (or for the benefit of)" a "financial institution." The Code defines "financial institution" to include a "Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, [or] savings and loan association" and, when any of the foregoing "is acting as agent or custodian" for a customer "in connection with a securities contract," such customer. However, there is a split of authority regarding what role a financial institution must play in the transaction for the safe harbor to apply. In *Merit Management Group*, the Seventh Circuit held that, for the safe harbor to apply, the financial institution must have a "beneficial interest" in the transferred assets. By contrast, five other circuit courts have held that the safe harbor applies even when the financial institution acts as merely a "conduit" or "intermediary." Given that distributions in leveraged buyouts have been shielded from avoidance in most jurisdictions when a financial institution acts as a "conduit" or "intermediary" for the distributions, wider adoption of the *Merit Management Group* rationale could have a substantial impact on chapter 11 practice. The case is a candidate for review by the U.S. Supreme Court.

Credit Bidding

In a decision arising out of the *Aéropostale* bankruptcy, the Bankruptcy Court for the Southern District of New York departed from recent decisions questioning a secured creditor's right to credit bid in the context of a section 363 asset sale. Prior to the bankruptcy, the private equity firm that owned the equity of Aéropostale was also a secured lender to the company. When Aéropostale filed for bankruptcy and sought to sell assets, it asked the court to

equitably subordinate the claims of the private equity firm and limit its ability to credit bid for the assets. The court declined to do so, permitting the firm to credit bid the full amount of its secured claim. The court held that the potential "chilling effect" of a credit bid on other bidders is not, on its own, "cause" to limit a secured creditor's right to credit bid, and that the creditor's status as an equity holder also did not provide cause to prevent the bid. Although courts will undoubtedly continue to scrutinize credit bids, *Aéropostale* reaffirms that, absent extraordinary circumstances involving misconduct, credit bidding is an important protection for secured creditors and will generally be permitted in a bankruptcy auction.

Puerto Rico

Puerto Rico continues to grapple with an unprecedented financial crisis. Efforts to restructure the island's roughly $70 billion of public debt have been complicated by Puerto Rico's status as a U.S. territory, which renders its municipalities and public corporations ineligible to file for bankruptcy under chapter 9 of the Bankruptcy Code. In 2014, Puerto Rico attempted to enact its own bankruptcy law, the "Recovery Act," to allow certain public issuers to restructure their obligations through a local court process. In June 2016, however, the U.S. Supreme Court struck down the Recovery Act as inconsistent with federal bankruptcy law, which bars states and localities from enacting their own bankruptcy schemes.

In the wake of the Supreme Court's decision, Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), which imposed a stay on collection of certain Puerto Rican public debts, thereby barring suit for nearly $2 billion in public bond payments that were to come due in early July of 2016. PROMESA also imposes a federally-appointed "oversight board," to which officials must submit a "fiscal plan," and allows for the restructuring of public debt (through a bankruptcy-type process in federal court). With PROMESA in effect, and a new governor sworn in as of January 2, 2017, Puerto Rico is expected to work with the oversight board on measures to alleviate the debt crisis. These measures may include budget cuts, privatization of government services and negotiated amendments to existing debt obligations.

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