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Corporate Bankruptcy and Restructuring: 2019–2020

2019 did not turn out to be the year of economic downturn that some had predicted. The credit markets were strong, and while the number of large chapter 11 filings increased, corporate distress was largely industry-specific: companies in particular industries were the subject of product liability and similar mass tort claims, and the retail, oil-and-gas, and healthcare sectors faced challenges specific to their markets.

Looking ahead to 2020, we expect to see more of the same: continued focus on mass tort issues across multiple industries, as well as difficulties in segments of the retail, energy, and healthcare sectors. We discuss below some of this past year's trends and developments and expectations for the coming year.

A New Era of Mass Tort Bankruptcies

This past year saw a notable increase in the use of chapter 11 to address mass tort litigation. Companies and other organizations that have filed include developers of opioid prescription drugs (Purdue and Insys), producers and sellers of talc that allegedly contained asbestos (Imerys), an electric utility blamed for causing wildfires (Pacific Gas & Electric), and dioceses of the Catholic Church facing sexual abuse claims. The use of the bankruptcy process to address mass tort liability reflects a growing recognition that chapter 11, while imperfect, provides tools for dispute resolution that are not generally available in federal or state courts.

In the past, chapter 11 has been used successfully to address product liability claims arising from exposure to asbestos (Johns-Manville and many others), silicone breast implants (Dow Corning), and the Dalkon Shield intrauterine device (A.H. Robins). For companies that have insufficient assets to pay claims in full, bankruptcy ensures that the debtor's limited assets are distributed equitably among claimants, including "future" claimants (those whose claims have not yet manifested). Chapter 11 can allow companies with tort liabilities to maintain operations, thereby continuing to generate funds to make payments over time, while providing a respite from defending lawsuits and a platform to negotiate settlements. Bankruptcy also provides a mechanism for centralizing the resolution of large numbers of tort claims, including through a court estimation of the aggregate liability, greatly reducing litigation costs and increasing the potential for a global settlement.

The wave of asbestos-related bankruptcies in the 1980s led Congress to enact Bankruptcy Code provisions to facilitate reorganization of debtors facing asbestos claims by establishing a plaintiffs' trust funded by cash, proceeds of insurance policies, and equity in the reorganized debtor. In exchange for contributing to the trust, the debtor and other contributors receive a "channeling injunction," which "channels" all existing and future claims to the trust. Upon resolution of the bankruptcy, such claims are brought against and paid by the trust, the debtor is discharged, and other contributors are released from further liability. While the relevant Bankruptcy Code provisions apply by their terms only to asbestos-related claims, similar mechanisms have been used (or are currently contemplated) in the bankruptcies of Takata (defective airbags), Pacific Gas & Electric (wildfire damages), and several Catholic dioceses (abuse claims).

The bankruptcy process can also prove useful for companies that have subsidiaries facing mass tort claims. In certain circumstances, courts have been willing to extend key benefits of bankruptcy to non-debtor third parties, including equity owners, where the non-debtors' liability (if any) is derivative of the debtor's liability and the non-debtor makes a substantial contribution to a settlement. In *Purdue*, for example, the bankruptcy court has entered a temporary stay of both governmental and private actions against Purdue's shareholders, who have not filed for bankruptcy. In other cases, courts have extended the benefit of a channeling injunction to non-debtors, including parent companies, that contribute to a plaintiffs' trust. Extending such protections to non-debtors remains a subject of some controversy, especially outside the asbestos context. But as the new wave of cases makes its way through the courts, we expect debtors, parent companies, and plaintiffs alike to continue to look to chapter 11 for creative solutions to mass tort problems.

<u>Liquidations in the Retail Sector</u>

Despite strong consumer spending and low unemployment, the rise of online shopping continued to place enormous pressure on brick-and-mortar retailers in 2019, pushing a significant number of major retailers, particularly in the apparel sector, into bankruptcy. Bankrupt retailers laid off tens of thousands of workers in 2019, over two-thirds of all bankruptcy-related job cuts, in a year in which such layoffs were the highest since 2005. Some lawmakers have taken notice: New Jersey recently enacted legislation, widely known as the "Toys 'R' Us bill," mandating employee severance and an increased notice period of 90 days for layoffs by companies with more than 100 employees.

Chapter 11 can be an effective tool to help retailers shed or renegotiate burdensome leases, delever their balance sheets, and obtain financing against assets, such as below-market leases, that are difficult to finance outside of bankruptcy. But if a retailer's core business loses money, chapter 11 cannot fix that problem, and most of 2019's major retail bankruptcies resulted in liquidations, closed stores, and terminated employees. Payless ShoeSource, for example, which delevered its balance sheet in chapter 11 in 2017, filed a "chapter 22" just 18 months later, and announced on the first day that it would close all of its approximately 2,500 North American stores. Other retailers, like Charlotte Russe and Barneys, filed chapter 11 petitions with hopes to reorganize, but failed to find buyers for their profitable stores and pivoted to liquidations.

When retailers have failed to reorganize, sales of inventory and real estate interests have principally been used to fund recoveries of secured lenders, with little if any value being left for unsecured creditors. Brand names and related intellectual property are a potential source of value as well, though valuations vary widely by company.

The challenges to the retail industry have recently led to a number of "administratively insolvent" cases, meaning that the debtor's assets are insufficient to pay even the claims of post-petition providers of goods and services. And while the Bankruptcy Code expressly requires that post-petition claims be paid in full to confirm a chapter 11 plan, some debtors have devised a workaround: they have offered vendors immediate distributions on their claims (at a fraction of their face amount) in exchange for waiving their right to be paid in full. Vendors are often willing to agree to take discounts because the alternatives, including conversion to a chapter 7 case, could leave them with no recovery at all.

The Importance of Early Engagement

While chapter 11 has long offered an attractive tool for distressed companies to restructure, its significant (and rising) costs, slow pace, and litigiousness have led both debtors and creditors to seek to minimize the time spent in bankruptcy. Prepackaged and prenegotiated plans have grown in popularity: approximately 65% of large chapter 11 cases in which plans were confirmed between 2016 and 2018 were prepackaged or prenegotiated filings, compared to 37% between 2010 and 2015. The last year saw prepackaged plans confirmed at record speeds: Acosta, Inc.'s parent company confirmed a plan in 13 days, and FullBeauty Brands spent less than 24 hours in bankruptcy, the fastest chapter 11 plan confirmation ever. Some companies, like Michigan-based Syncreon, have even chosen to reorganize under the laws of other countries, in particular the

United Kingdom, which offers a more streamlined and less expensive means of restructuring funded debt.

A consequence of the desire for speed is that, in more and more cases, debtors negotiate chapter 11 plans — including exit financing — outside of court. Much of the "action" occurs prior to or early in a case, such that creditors that organize and engage with the debtor early in the process can reap rewards.

An Eighth Circuit Court of Appeals decision in *Peabody Energy* illustrates the advantage to creditors of proactive engagement with the debtor. In that case, certain secured creditors agreed to mediate a dispute with the debtor over the extent of their collateral, and the mediation resulted in a plan that involved a rights offering and private placement of preferred stock. The creditors that agreed to backstop the rights offering and private placement stood to receive over $78 million in fees, as well as discounted prices for the new securities. Other creditors could buy preferred stock at a discount if they acted quickly, but would not get the fees. Nonparticipating creditors objected to the plan, arguing that it discriminated unfairly among creditors. But the bankruptcy court confirmed the plan, and the Eighth Circuit affirmed, holding that the discrimination was not unfair because the special treatment was provided on account of the participating creditors' new commitment to backstop, not their pre-petition claims.

Circuits Remain Split Over Make Wholes

"Make whole" premiums — provisions in loan documents that require an additional payment to the lender upon an optional redemption or other repayment prior to the scheduled maturity of the debt — continue to be an active source of bankruptcy litigation.

Courts have reached different results as to whether premiums that would be payable outside of bankruptcy in the event of an early repayment are payable when, under the loan's terms, the debt maturities have been accelerated due to a bankruptcy filing. In 2017, the Second Circuit held in *Momentive* that, in the absence of specific language preserving a make whole claim, loans that are automatically accelerated as a result of a chapter 11 filing are treated not as having been redeemed at the debtor's option but, instead, as being repaid post-maturity, meaning that a make whole was *not* payable. This departed from the Third Circuit's 2016 holding in *Energy Future Holdings* that a debtor's decision to refinance secured debt in bankruptcy *was* a voluntary "redemption" subject to a make whole.

The Fifth Circuit added additional uncertainty in recent months, issuing — and then withdrawing — an opinion in *Ultra Petroleum* that strongly suggested that make whole premiums triggered by the debtor's bankruptcy filing should be disallowed, at least in the case of unsecured or undersecured debt. The initial opinion concluded that a make whole premium is the "economic equivalent" of interest that was "unmatured" as of the petition date, because it is intended to compensate a lender for lost interest over the life of the loan. As "unmatured interest," the make whole would be disallowed under section 502(b)(2) of the Bankruptcy Code (except perhaps in a solvent case where all other creditors are paid in full). The court did not address whether oversecured creditors, who are entitled to "interest" and "reasonable fees, costs, or charges" by section 506(b) of the Bankruptcy Code, can enforce make whole premiums.

The Fifth Circuit later substituted an opinion that removed much of its discussion of make wholes and suggested only that make whole premiums could, depending on "the dynamics of the individual case," be disallowed as unmatured interest. It remains to be seen whether other courts will adopt the reasoning of the initial opinion in *Ultra Petroleum* to find that the Bankruptcy Code's disallowance of unmatured interest requires invalidating make whole premiums. Regardless, the existing split in authority will continue to fuel litigation surrounding the treatment of make wholes and will cause participants in the corporate debt market to continue to focus on the contractual make whole language at the issuance stage.

Richard G. Mason
Amy R. Wolf
Scott K. Charles
Joshua A. Feltman
Emil A. Kleinhaus
John R. Sobolewski
Neil M. Snyder
Joseph C. Celentino