Client Update
Restructuring Round-up: Two Steps Forward, One Step Back

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In three key appellate rulings in the last two weeks, appellate courts clarified the law as it relates to out-of-court exchange offers and structured dismissals of chapter 11 cases, but created a concerning new front of uncertainty with respect to the availability of nonconsensual third-party releases, which in certain cases can be an important element of protection for directors, officers, employees and sponsors of companies in chapter 11.

PART ONE: STRUCTURED DISMISSALS AND PRIORITY-SKIPPING SETTLEMENTS – A CLARIFYING RULING, CONFIRMING THE ABSOLUTE PRIORITY RULE APPLIES TO DISMISSALS

In a highly anticipated decision, on March 22, 2017, the U.S. Supreme Court ruled on the acceptable parameters for bankruptcy cases that result in structured dismissal—that is, restructuring efforts that use key features of the Bankruptcy Code, but fall short of confirming a chapter 11 plan of reorganization or liquidation, and instead seek an order dismissing the bankruptcy case and providing releases and other protections. In *Czyzewski v. Jevic Holding Corp.*, 2017 WL 1066259 (Mar. 22, 2017), the Supreme Court left open the possibility of structured dismissal as a business liquidation strategy, while clarifying that structured dismissals may *not* be used to provide value to junior creditors while skipping creditors with claims higher up on the priority scale without the consent of the senior creditors.

The *Jevic* case arose from a failed leveraged buyout in which Sun Capital bought Jevic Transportation Corp. in 2006, only to see the company land in chapter 11 two years later. In the chapter 11 case, a group of former Jevic employees claimed that the company had violated the federal Worker Adjustment and Retraining Notification (WARN) Act by failing to give workers at least 60-days' notice of termination. That litigation ultimately led to a $12.4 million judgment

against the company, of which $8.3 million was entitled to priority wage claim status ahead of general unsecured claims under the Bankruptcy Code.

The committee of general unsecured creditors also brought litigation in the bankruptcy case, suing Jevic's private equity sponsor and its secured lenders on the theory that the leveraged buyout had "hastened Jevic's bankruptcy by saddling it with debts that it couldn't service." The company, the creditors' committee and the other defendants agreed to settle that litigation through a "structured dismissal"—a transaction that would result in the company's assets being assigned to a liquidation trust that would pay some priority and administrative claims in the bankruptcy case and then make distribution to general unsecured creditors, but that expressly would not make any distribution on account of the priority WARN claims, which would have been paid before any general unsecured creditors under the absolute priority rule that applies to plans of reorganization and liquidation in chapter 11.

The WARN Act claimants, predictably, objected to this course of action, but the bankruptcy court, district court and Third Circuit Court of Appeals all held that the Bankruptcy Code's absolute priority rule only applied to chapter 11 plans, not settlements. Accordingly, the lower courts held that in certain "rare instances" a debtor could exit bankruptcy with a structured dismissal that did not comply with priority rules.[1]

Last week, the Supreme Court reversed these lower court decisions, holding that bankruptcy courts "may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors." Jevic's plan supporters had argued that the bankruptcy court has broad power to grant substantive relief in an order dismissing a chapter 11 case, based on statutory language stating default rules for a dismissal (essentially, that the situation returns to the *status quo* as of immediately before the bankruptcy) but also giving a court discretion to "order otherwise."[2] While the Supreme Court left open the possibility that a bankruptcy court can include non-*status quo* relief as part of a dismissal, it held that the "order otherwise" provision was not explicit enough to allow a court to approve distributions that violate the priority rules stated elsewhere in the Bankruptcy Code.

Notably, the Supreme Court distinguished (and implicitly approved) other situations in bankruptcy cases in which courts have approved distributions that are inconsistent with the priority rules, such as "first-day" motions to pay

[1] *In re Jevic Holding Corp*., 787 F.3d 173, 180 (3d Cir. 2015).
[2] 11 U.S.C. § 349.

prepetition employee wages, "critical vendor" claims and "roll-up" DIP-financing loans. As compared to "structured dismissals," these other situations arise frequently in chapter 11 cases, and the Supreme Court noted that they generally have "significant Code-related objectives that the priority violating distributions serve."

It is likely that parties in bankruptcy will still attempt structured dismissals in some liquidating chapter 11 cases in an effort to avoid the potential cost and delay of a chapter 11 plan process; and by not explicitly prohibiting structured dismissals, the *Jevic* ruling may embolden parties and courts to continue using the mechanism even though there is no clear Bankruptcy Code authority for it. What is clear, however, is that a structured dismissal may not be used solely for the purpose of gaining leverage over one class of priority creditors by ignoring their claims while paying others under the guise of a settlement. Accordingly, parties may now need to be more creative, or in some cases more compromise-oriented, in handling restructuring situations when a traditional chapter 11 plan is not feasible, including possibly structuring settlements apart from a final dismissal or having the distribution to junior creditors come directly from the secured creditors as a "gift." In addition, debtors and other parties are likely to rely upon *Jevic* as authority to make certain priority-skipping payments during a case that are necessary to preserve the debtor as a going concern.

PART TWO: EXCHANGE OFFERS AND TIA SECTION 316(b) – RETURNING TO THE OLD NORMAL

On March 21, 2017, the U.S. Court of Appeals for the Second Circuit issued a ruling that may represent the final word in the long-running dispute between Education Management Finance Corp. ("EDMC") and its bond creditor, Marblegate Asset Management, who had sought to scuttle EDMC's workout transaction. As we previously reported,[3] Marblegate had argued that section 316(b) of the Trust Indenture Act ("TIA") prohibited EDMC's proposed restructuring transaction—which had been supported by 98% of its lenders and bondholders—because the transaction did not protect Marblegate's practical

[3] We discussed the earlier *Marblegate* decisions in Client Updates on January 25, 2015, April 25, 2016 and January 18, 2017 and in the fall 2015 issue of the Debevoise Private Equity Report: http://www.debevoise.com/insights/publications/2015/01/expansive-trust-indenture, http://www.debevoise.com/insights/publications/2016/04/28-law-firms-publish-white-paper, http://www.debevoise.com/insights/publications/2017/01/second-circuit-court-of-appeals, http://privateequityreport.debevoise.com/the-private-equity-report-fall-2015-vol-15-no-2/bond-restructuring-challenges.

right of payment on its bonds (despite the fact that EDMC was overlevered and Marblegate's likely recovery in a bankruptcy would have been nothing).[4]

Judge Failla in the Southern District of New York had taken a broad view of TIA section 316(b) and held that EDMC's largely consensual restructuring was illegal, upending what had until then been a general consensus among finance lawyers and restructuring professionals that only formal amendments to indenture provisions governing the amount and timing of payments required unanimous noteholder consent under that provision. This ruling, combined with similar rulings in pending litigation associated with the Caesars bankruptcy, had caused concern about the legality of certain exchange offers and increased execution risk in closing those deals.[5] In January 2017, however, the Second Circuit overruled the district court, siding with the previously understood interpretation of the TIA. At the same time, the court reminded aggrieved noteholders that they still had other avenues of recovery, including fraudulent conveyance and successor liability claims.[6] Although not mentioned in the decision, fiduciary duty claims are another possible remedy.

The plaintiff in *Marblegate* took another run at the Second Circuit after the January decision, asking the court to rehear the case *en banc*. That request was denied on March 21, and the January decision will therefore stand unless the plaintiff seeks U.S. Supreme Court review and the Court decides to do so—an unlikely result in the absence of a circuit split and where the circuit court has reaffirmed what was previously settled law. Accordingly, we believe the Second Circuit's ruling represents the return to a now-more-settled *status quo*, where exit consents and covenant stripping are generally permissible and hold-out bondholders cannot use section 316(b) to disrupt out-of-court exchanges that steer clear of amending payment and maturity terms.

PART THREE: THIRD-PARTY RELEASES – A NEW CASE TO WATCH, QUESTIONING BANKRUPTCY PROTECTIONS FOR DIRECTORS, OFFICERS, SPONSORS AND EMPLOYEES

On March 17, 2017, the U.S. District Court for the District of Delaware, acting as an appeals court from a bankruptcy judge's decision, issued a surprising ruling in *In re Millennium Lab Holdings II, LLC*, 2017 WL 1032992 (D. Del. Mar. 17, 2017), which questioned the bankruptcy court's constitutional authority to approve nonconsensual third-party releases in a chapter 11 plan—releases of claims that

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[4] *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542, 554 (S.D.N.Y. 2015); *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592, 605 (S.D.N.Y. 2014).

[5] *See BOKF, N.A. v. Caesars Entm't Corp.*, 144 F. Supp. 3d 459, 476-477 (S.D.N.Y. 2015).

[6] *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp.*, 846 F.3d 1, 16 (2d Cir. 2017).

creditors may have against third parties such as directors, officers, employees, shareholders and other plan sponsors. These releases can be a key part of the consideration given to parties who facilitate a consensual chapter 11 reorganization.

In *Millennium*, the bankruptcy court had confirmed a chapter 11 plan that included broad third-party releases—covering the debtors' officers and directors, founder and 55% shareholder, and 45% private equity shareholder—from claims of the debtors' creditors. The third-party releases were nonconsensual because creditors could not "opt out" of the releases. Non-consenting creditors who had pending litigation against certain released parties appealed the plan confirmation.

The debtors moved to dismiss the appeal as moot because the plan had already become effective. The district court denied the motion, not by focusing on mootness, but on a broader issue that the parties had scarcely briefed or argued before the bankruptcy court: whether the bankruptcy court had the constitutional authority to grant the releases in the first place. Specifically, the district court asked whether jurisdictional limitations set out in the U.S. Constitution place third-party releases beyond the reach of the bankruptcy court even though the United States Code appears to give the court authority over them (i.e., classifying the confirmation of chapter 11 plans as "core proceedings" that may be heard by bankruptcy courts under 28 U.S.C. § 157(b)).[7] Typically, a bankruptcy court may not decide disputes that do not involve a chapter 11 debtor. Until now, to the extent bankruptcy courts have considered this issue in approving third-party releases in chapter 11 plans, they have relied (either explicitly or implicitly) on the "public rights" exception, which allows resolution of core bankruptcy matters by non-Article III judges, reasoning that the releases are a core element of the reorganization itself. In rejecting that reasoning, the district court held that nonconsensual third-party releases were not "public rights." Accordingly, the district court held that (a) a bankruptcy court must have both statutory and constitutional authority to approve nonconsensual third-party releases and (b) the "public rights" exception isn't available to supply the required constitutional authority. The Court then remanded the case for the bankruptcy court to determine whether it had some other constitutional authority to approve the nonconsensual third-party releases in the debtors' plan, finding that the court did not fully consider this issue.

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[7] *See Stern v. Marshall,* 131 S. Ct. 2594 (2011) (holding that certain counterclaims by debtors against creditors were outside a bankruptcy court's constitutional authority to adjudicate on a final basis, even if they were within the statutory authority of the bankruptcy court).

Depending on the outcome on remand and in any further appeals, the district court's ruling in *Millennium* could make it more difficult for debtors to obtain nonconsensual third-party releases in chapter 11 plans in the District of Delaware. Specifically, the *Millennium* decision suggests that nonconsensual third-party releases require the approval by an Article III court (a federal district court) which would add another layer of difficulty—and delay—to the chapter 11 plan confirmation process.[8] If that is the case, it may become more difficult for directors, officers, shareholders and other plan supporters to bargain for full, broad releases as part of a plan. That said, while the full impact of the *Millennium* decision remains to be seen, debtors and other parties can take some comfort from the fact that the decision is focused on nonconsensual releases, which already face significant obstacles. Consequently, the common practice of seeking broad consensual releases, using strategies such as adding opt-out provisions and providing that an affirmative vote on a plan automatically counts as consent to the plan releases, could take on increased importance in Delaware.

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Please do not hesitate to contact us with any questions.

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[8] The end result might be similar to the process for handing asbestos-claim injunctions under section 524(g) of the Bankruptcy Code, which requires an order from a district court.