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Did 2009 Change the Bankruptcy Landscape **Forever?**

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IN 2009, during the worst financial crisis since the Great Depression, businesses, financial institutions and the U.S. government called upon and tested the creativity and power of the Bankruptcy Code to help save some of the country's largest corporations and, perhaps, the overall global economy.

Without the ability to tap credit markets in any material way, companies resorted to quick asset sales and pre-packaged bankruptcies that sped through the court system. As a counter-balance, strong and aggressive assertion of creditors rights culminated in court rulings that have yet to be resolved.

History will be the ultimate judge as to whether or not the measures taken during this economic crisis were successful and beneficial. In the interim, with the U.S. economy still recovering, bankruptcy and non-bankruptcy practitioners alike must consider the effect and potential use of the offensive and defensive weapons that were used in the past year. This article provides an overview of some of the key cases that emerged from 2009 and their potential impact in 2010 and beyond.

Background

As a backdrop, in 2009, the U.S. high yield bond default rate, which annually averages 4.7 percent, reached approximately 13.6 percent.¹ As a corollary, it could have been reasonably anticipated that the number of business bankruptcy filings would similarly reach epic proportions.

However, despite the double digit default rate, business bankruptcies rose by 52 percent for the 12-month period ending Sept. 30, 2009 when compared to the same 12-month period ending Sept. 30, 2008.² Although the increase is



significant, those approximately 58,000 business bankruptcy filings fell short of the high water mark of approximately 80,000 such filings that took place in 1986 and 1987.³

The fact that the number of business bankruptcies did not explode may be explained, at least in part, by the lack of financing necessary to support a bankruptcy filing, including the need for exit financing. The lack of financing forced some distressed companies to succumb to foreclosure or negotiate out-of-court restructurings that either deferred maturities or exchanged debt for equity without fixing the company's operational issues.

When companies did enter Chapter 11, in general, it was with limited financial resources and with an eye toward quick strike sales or reorganizations. The clearest examples of this strategy are the Chapter 11 cases of Chrysler and General Motors.

Because such companies were saddled with billions of dollars of pre-petition legacy pension liabilities, warranty and dealership obligations and secured debt owed to the U.S. Treasury and other secured lenders, the U.S. government supported a sale of virtually all of the assets of these companies free and clear of liens and interests to new entities in roughly 40 days pursuant to §363 of the Bankruptcy Code.⁴ These new entities were owned by combinations of the U.S. and Canadian governments, general

unsecured creditors, retirees and, in the case of Chrysler, the Italian car maker Fiat.

In such restructurings, certain prepetition junior creditors came away owning equity in the new company while certain senior creditors did not. Because these sales resulted in pre-petition creditors receiving an ownership stake in the new company, the sales were objected to by certain parties on several grounds, including that the sales were sub rosa plans and violated bankruptcy's absolute priority rule because they provided junior creditors with an ownership interest in the new entity without satisfying more senior claims in full.⁵

In both Chrysler and General Motors, the sales were approved by the bankruptcy courts on the basis that, among others, to the extent junior creditors received any value, it was provided by the new owner, rather than the debtor. Therefore, the sales were not deemed to be sub rosa plans and the priority scheme of the Bankruptcy Code was not violated.⁶

The appropriateness of the sales has been debated by scholars and practitioners alike.⁷ Was it a straight sale of assets to a third party or a disguised plan of reorganization that did not comply with the disclosure statement or creditors solicitation requirements? The debate is largely moot, however, as a result of the affirmance of the bankruptcy courts' decisions by the U.S. Court of Appeals for the Second Circuit and the U.S. Supreme Court.⁸ Nonetheless, practitioners are now evaluating whether or not a similar structure can be implemented in far less dramatic circumstances for cases smaller in size and scope.

Other Creative Sales Processes

Chrysler and General Motors are not the only examples of creative sales processes conducted in 2009.

Sales of assets to equity holders or insiders became more prevalent. Such sales were approved as long as the relationship was fully disclosed, an independent board approved the sale, no better offers existed and the sale was in the best interests of creditors and the estate.⁹ In those

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circumstances, courts justified the sale on the basis that the absolute priority rule may not have been technically violated because the shareholder provided consideration in order to purchase assets through a new corporate vehicle.

More recently, the U.S. District Court for the Eastern District of Pennsylvania reversed a decision on appeal from the U.S. Bankruptcy Court for the Eastern District of Pennsylvania and held that a secured creditor did not have a right to credit bid its claim at a sale of the debtor's assets when such sale was conducted pursuant to a plan of reorganization.¹⁰

In that case, the debtors owed approximately \$300 million to a group of senior lenders whose debt was secured by substantially all of the debtors' assets. However, at the time of their Chapter 11 filing, the debtors valued their assets at an amount substantially lower than the amount of the debt, making the lenders significantly undersecured.

The debtors filed a disclosure statement and plan of reorganization that provided the lenders with both a secured claim equal to the fair market value of the collateral and an unsecured deficiency claim for the amount of the deficiency. The plan proposed to sell substantially all of the debtors' assets through a public auction. The plan identified a "stalking horse bidder" and proposed bidding procedures that would subject the bid to higher and better offers.

Significantly, and controversially, the bidding procedures prohibited the lenders from credit bidding their debt as part of a bid for the debtors' assets. The lenders objected to the bidding procedures claiming that the restriction on their right to credit bid was not supported by the Bankruptcy Code.

The debtors argued that when a sale is conducted through a plan under §§1123 and 1129 of the Bankruptcy Code (as opposed to a stand-alone motion under §363 of the Code), secured lenders did not have a right to credit bid so long as the plan provides the lenders with the "indubitable equivalent" value of their secured claim. In this case, the debtors' plan proposed to distribute cash and property to the lenders in an amount equal to the value of the collateral securing their claim, but not the face amount of the debt.

The district court's opinion was appealed to the Third Circuit Court. Oral arguments were presented on Dec. 15, 2009, but a decision has not yet been issued. The district court's decision, if affirmed by the Third Circuit, may greatly affect the way debtors and lenders alike approach debt restructurings.

From the Creditors' Perspective

On the flip side of the coin, when creditors are involved in cases where their rights and prospective recoveries are threatened, they will inevitably sharpen their weapons and strike back to find currency for their constituents.

Even prior to 2009, where creditor recoveries appeared insufficient, creditor committees and other estate fiduciaries have not been shy about commencing lawsuits against deep pockets with potential liability.¹¹ In 2009, creditors became more aggressive and the differential in recoveries became greater.

By way of example, in *In re Touse*, the U.S. Bankruptcy Court for the Southern District of Florida found that certain senior lenders received a fraudulent transfer that resulted in the avoidance of the lenders' liens on Touse's assets.¹² Although the bankruptcy court's decision is on appeal, as it currently stands, the lenders are required to repay \$403 million and interest back to the Touse estates.

What Effects for the Future?

Can 2009 be characterized as the year where "desperate times require desperate measures"? Or is it more accurate to say that the elasticity of the Bankruptcy Code proved to be a game saver for the economy?

Without a doubt, the financial crisis of 2009 tested the outer limits of asset sales under Code §§363, 1123 and 1129. In the context of General Motors and Chrysler, perhaps the ends justified the means: Jobs were saved and American icons endured. Or, perhaps, did certain debt holders bear the burden of such restructurings?

The parties will never fully agree. But the bankruptcy bar must now make sense of how those decisions can be applied (if at all) in the future. Thus, the question must be asked:

Will the case law that emerged in 2009 set an irreversible and dangerous precedent that may be exploited in the future by debtors under less drastic circumstances? Or did these decisions unlock strategic pathways that were always available but never truly tested under the most intense of circumstances?

The questions concerning the unprecedented use of the Bankruptcy Code will only be answered in time after parties bring matters before the courts for adjudication. What is likely, however, is that parties will attempt to replicate the structures that were successful in 2009. Indeed, the principle of stare decisis should dictate that the structures implemented in large cases can be applied again.

Some of the courts' opinions emphasized that the emergency context in which the cases arose played an important part in justifying the sales.¹³ Implicitly, therefore, the results may not have been the same in a less urgent context. Nonetheless, it is not difficult to imagine that in another circumstance a party (perhaps one with only a fraction of the debt or assets of a large multinational company) may attempt to argue that its client faces an emergency and that unless a particular sale structure is put in place, jobs may be lost.

If consistency means anything, should those parties, even if they do not have billions of dollars to reorganize, not be afforded the same protections and opportunities afforded to some of the largest companies? Would a ruling to the contrary create an unintended division between larger and smaller corporations?

In either event, it appears certain that the jurisprudence from 2009 will be replicated in 2010 and perhaps beyond, leaving ample opportunity for these questions to be answered.



1. Aneiro, Michael, "Fitch Sees US Default Rate Falling in 2010 to 6-7% Range," THE WALL STREET JOURNAL, Dec. 9, 2009,

available at <http://online.wsj.com/article/BT-CO-20091209-706426.html>.

2. Bureau of National Affairs, Vol. 21, No. 47 (Dec. 3, 2009) at 1702.

3. American Bankruptcy Institute, "Annual Business and Non-Business Filings by Year (1980-2008)," available at <http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=57826>.

4. 11 U.S.C. §363.

5. *Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 118 (2d. Cir. 2009), vac'd by 2010 U.S. App. LEXIS 1521 (2d Cir. Jan. 25, 2010) (appeal dismissed as moot).

6. See generally, *In re Chrysler LLC*, 405 B.R. 84, 98-99 (Bankr. S.D.N.Y. 2009); *In re GMC*, 407 B.R. 463, 496-98 (Bankr. S.D.N.Y. 2009).

7. Ball, Corinne and Lebioda, Nathan, "Just Another 363 Sale—How Chrysler Sold Itself and Kept Creditor Priorities Intact," 4 *INSOL World: The Q. Journal of INSOL Int'l*, 23-24 (2009); Lauria, Thomas, "The Chrysler Story: Chapter 11 Glory or Chapter 11 Gory," 4 *INSOL World, The Q. Journal of INSOL Int'l*, 26-27 (2009); Roe, M.J. and Skeel, D., "Assessing the Chrysler Bankruptcy," (SSRN Working Paper) (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426530.

8. *Ind. State Police Pension Trust*, 576 F.3d at 127.

9. See, e.g., *In re Eclipse Aviation Corp. et al.*, Case No. 08-13031, Docket No. 446 (Bankr. D. Del. Jan 23, 2009) (although the sale was approved by the court, it ultimately did not close).

10. *In re Phila. Newspapers, LLC*, 418 B.R. 548 (E.D. Pa. 2009).

11. See, e.g., *In re Mervyn's Holdings LLC*, Case No. 08-11586 (Bankr. D. Del. 2008); *Henderson v. Powermate Holding Corp. (In re Powermate Holding Corp.)*, 394 B.R. 765 (D. Del. 2008); *Big Lots Stores Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169 (Del. Ch. 2006).

12. *Official Comm. of Unsecured Creditors of Touse Inc. v. Citicorp N. Am. Inc. (In re Touse)*, 2009 Bankr. LEXIS 3311, at *278-79 (Bankr. S.D. Fla. 2009).

13. *In re Chrysler LLC*, 405 B.R. 84, 96-97 (Bankr. S.D.N.Y. 2009); *In re GMC*, 407 B.R. 463, 493 (Bankr. S.D.N.Y. 2009).