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Central European Distribution Corporation's Chapter 11 Plan Incorporates Dutch Auction

On May 13, 2013, the U.S. Bankruptcy Court for the District of Delaware confirmed a prepackaged Chapter 11 plan of reorganization in the case of Central European Distribution Corporation (CEDC)[1] that incorporated an unmodified reverse Dutch auction. A reverse Dutch auction is a type of auction employed when a single buyer accepts bids from numerous sellers, and lowest-priced seller bids are accepted as winning bids.

The CEDC plan is perhaps the first instance of a Dutch auction process being incorporated successfully into a Chapter 11 reorganization plan. This precedent provides guidance for the use of Dutch auctions that may offer creditors distribution alternatives and maximize the utility of limited cash (or other limited property) available for distribution under a plan.

Background

CEDC is one of the largest vodka distributors in the world and the largest integrated spirit and beverage business in Central and Eastern Europe. CEDC faced financial challenges after expanding its business as a result of the global financial crisis and measures taken by the Russian government to reduce alcohol consumption. A public company, CEDC had substantial debt, including approximately $982 million of senior secured notes, $262 million of convertible notes and debt held by its largest stockholder, Roust Trading Ltd. CEDC faced growing liquidity issues that led it to focus on a balance sheet restructuring beginning in late 2012.

Ultimately, CEDC and its primary stakeholders negotiated a prepackaged Chapter 11 case. The prepackaged CEDC plan provided that holders of senior secured notes as a class would receive in the aggregate $650 million of new notes and $172 million in cash to be distributed pursuant to a Dutch auction procedure. Just over a month after CEDC commenced its voluntary Chapter 11 case, the Bankruptcy Court confirmed CEDC's prepackaged plan, which went effective on June 5, 2013.

The Dutch Auction

Under the terms of the CEDC plan, the holders of senior secured notes could elect (in exchange for their old notes) either new notes issued under the plan, or to participate in the plan-based Dutch auction to receive a distribution of cash. The CEDC plan effectuated an unmodified reverse Dutch auction procedure to determine which notes would be accepted by CEDC in exchange for the cash-out option.

In a traditional Dutch auction, named for the method by which tulips were traditionally sold, the price of the offering is set after taking in all bids and determining the highest price at which the offering can be sold. Parties then place a bid for the amount they are willing to buy in terms of quantity and price with the price going down until all offerings are sold.

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1 *In re Central European Distribution Corporation, et al.*, Case No. 13-10738 (CSS). Skadden represented CEDC.

Differently, in a reverse Dutch auction, there is one buyer and many competing sellers; the price of the sale item starts low and is continually increased, according to a specified increment, and at pre-set intervals. The lowest seller bids are accepted until the buyer's full procurement is satisfied.

Under the CEDC plan, senior secured noteholders electing the cash-out option (sellers in the auction) could indicate a cash election price to exchange (sell) their senior secured notes for between 65 to 85 cents in cash for each dollar in principal amount of senior secured notes. CEDC accepted for cash purchase the senior secured notes of bidding holders in order of the lowest to the highest bid price until the $172 million cash distribution pool was exhausted. CEDC first accepted for exchange the notes with a bid price less than the clearing price, and thereafter, notes with a bid price equal to the clearing price on a pro-rata basis. The clearing price was the lowest bid price accepted such that the aggregate purchase price to purchase all notes electing to participate in the cash option would equal or exceed the cash distribution pool available under the plan. Winning bidders who bid below the clearing price received their bid price, and not the higher clearing price.

Section 1123(a)(4)

The most significant legal issue surrounding CEDC's use of a Dutch auction in its Chapter 11 plan was compliance with Section 1123(a)(4) of the United States Bankruptcy Code, which requires that a plan provide the same treatment for each claim or interest of a particular class, unless the holder of the claim or interest agrees to less favorable treatment.[2]

Under CEDC's proposed plan, all holders of senior secured notes would not receive the same distribution. Individual noteholders were permitted to elect to receive either cash or new notes. Individual noteholders electing cash treatment would receive different cash consideration based on their self-selected bid price, with bids accepted by CEDC in its reverse Dutch auction procedure in order from lowest to highest, within a price range set by CEDC.

As the CEDC Dutch auction was the first of its kind under a Chapter 11 plan, no caselaw addressed whether a Dutch auction procedure satisfied Section 1123(a)(4) requirements. The few cases that addressed Section 1123(a)(4) turned on whether members of the same class under a Chapter 11 plan had the same opportunity to receive equal treatment, not on whether the class members received identical treatment.[3] Accordingly, in CEDC's case, because each holder of a senior secured note was given the same opportunity to participate in the Dutch auction, CEDC determined that the Dutch auction was a lawful mechanism. It was approved by the Bankruptcy Court without any objection from creditors or other parties in interest.

Mechanical Challenges Presented

Because of the unique nature of the transaction, CEDC had to address several mechanical issues in order to successfully effectuate the Dutch auction. Distributions had to be coordinated through domestic and international securities transfer clearing systems. While such clearing systems are generally experienced with Dutch auctions, they had no familiarity with how to implement a Dutch auction in connection with a plan of reorganization. The mechanics of the CEDC plan-based Dutch auction required extensive discussions and negotiations with the clearing systems to ensure that they were comfortable with the distribution process.

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2 11 U.S.C. § 1123(a)(4).

3 See, *e.g.*, *In re Washington Mut., Inc.* 442 B.R. 314, 355-56 (Bankr. D. Del. 2011); *In re Joint Eastern and Southern Dist. Asbestos Litig.*, 982 F.2d 721 (2d Cir. 1992); *In re Dana Corp.*, 412 B.R. 53, 62 (S.D.N.Y. 2008); *In re Mesa Air Group*, 2011 WL 320466 (Bankr. S.D.N.Y., January 20, 2011).

In order to give domestic and international clearing systems comfort, noteholders who had made their earlier bid and election decisions when voting on the plan were not thereafter permitted to trade their notes prior to the cash distribution date. Also, before any cash was distributed to noteholders electing to participate in the Dutch auction, the noteholders were required to confirm their holdings and complete a manual markdown of their notes.

The foregoing procedures added an additional level of complexity to the CEDC restructuring. Such procedures should be considered by those who are evaluating possible Dutch auction terms in future Chapter 11 plans.

Implications

CEDC's successful use of a Dutch auction in its prepackaged Chapter 11 reorganization suggests that Dutch auction strategies may become more common in the restructuring landscape.