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A Look at 2019 Court Decisions That May Shape Restructuring Issues in the Year Ahead

A series of decisions over the past year — on issues such as make-whole premiums, intercreditor agreements, backstops for rights offerings and nonconsensual third-party releases — will likely have a significant impact in 2020 on parties involved in bankruptcy proceedings.

Fifth Circuit Reverses Course on the Enforceability of Make-Whole Premiums in Chapter 11

On November 26, 2019, the U.S. Court of Appeals for the Fifth Circuit withdrew an opinion it issued earlier in the year in which it signaled that make-whole (or prepayment) premiums owed to unsecured or undersecured creditors are, as a matter of law, disallowed under the Bankruptcy Code. In its newly issued opinion, *In re Ultra Petroleum Corp.*, the Fifth Circuit removed the discussion of this issue while leaving intact its previous holding that a claim is impaired under the Bankruptcy Code only if the Chapter 11 plan itself — as opposed to the Bankruptcy Code — alters a claimant's legal, equitable or contractual rights.

Background

The debtor in this case, Ultra Petroleum Corporation and its affiliates (Ultra), is an oil and gas exploration and production company that filed for Chapter 11 in 2016 after a precipitous decline in oil prices. As of the bankruptcy filing, Ultra owed $1.46 billion under a note purchase agreement and $999 million under a revolving credit facility (the holders thereof, Funded Debt Creditors).

During the pending bankruptcy, oil prices rebounded to such a degree that Ultra became solvent. Consequently, Ultra's plan purported to leave the Funded Debt Creditors unimpaired and thus unable to vote on its plan. Specifically, Ultra proposed to pay them the "outstanding principal owed on those obligations, pre-petition interest at a rate of 0.1%, and post-petition interest at the federal judgment rate." The Funded Debt Creditors objected, arguing that they were impaired because the plan did not provide for payment of the make-whole premium that was triggered by the bankruptcy filing and post-petition interest at the contractual default rate.

The bankruptcy court disagreed with Ultra that the Funded Debt Creditors were unimpaired. According to the court, to be unimpaired, they must be paid everything they are owed under state law, even if such payments are otherwise disallowed by the Bankruptcy Code. Ultra sought, and was granted, a direct appeal to the Fifth Circuit.

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Fifth Circuit's Holding

The Fifth Circuit reversed the bankruptcy court, holding that disallowance of a claim due to the application of the Bankruptcy Code does not render such claim impaired. Relying on the Third Circuit's decision in *In re PPI Enterprises (U.S.)*, the Fifth Circuit observed that "'a creditor's claim outside of bankruptcy is not the relevant barometer for impairment,'" and held that the court must examine whether the plan itself limits a creditor's rights. The Fifth Circuit interpreted Section 1124(1) — which provides that a claim is unimpaired where the plan "leaves unaltered the [holder's] legal, equitable, and contractual rights" — to mean that the Chapter 11 plan, not the Bankruptcy Code, must do the altering in order for a claim to be impaired.

Because the bankruptcy court had not ruled on whether the Bankruptcy Code disallows the make-whole premium and default post-petition interest, the Fifth Circuit remanded these questions to the bankruptcy court to answer in the first instance.

Fifth Circuit Changes Its Thinking on Make-Whole Premiums

Notably, in the Fifth Circuit's initial opinion, without ruling on the issue, it strongly telegraphed that make-whole premiums are unenforceable under the Bankruptcy Code. In that opinion, the court observed that (i) make-whole premiums constitute unmatured interest, (ii) Bankruptcy Code Section 502(b)(2) should be construed to bar such interest and (iii) the debtor-solvent exception (which, if applicable, would require payment of a make-whole premium) likely did not exist. The Fifth Circuit's newly issued opinion removed the discussion relating to the first two observations, and with respect to the debtor-solvent exception, reversed course, noting that "[o]ur review of the record reveals no reason why the solvent-debtor exception could not apply."

Implications

While the Fifth Circuit removed the controversial portions from its initial decision, the newly issued *Ultra* opinion remains noteworthy because it is only the second court of appeals decision to explicitly adopt a plan-impairment approach to Bankruptcy Code Section 1124. As a creditor's ability to vote for or against a Chapter 11 plan depends on whether its claim is impaired, the *Ultra* decision provides critical guidance to parties involved in a Chapter 11 case. In the Fifth Circuit, a creditor will be unimpaired and therefore cannot vote on a Chapter 11 plan where a debtor pays, subject to the Bankruptcy Code's disallowance provision, all that is owed under state law. The lasting impact of the decision, however, remains to be seen, as the bankruptcy court must now answer whether the Bankruptcy Code disallows the make-whole premium and default post-petition interest.

"Fifth Circuit Reverses Course on the Enforceability of Make-Whole Premiums in Chapter 11" was adapted from an article authored by Lisa Laukitis and Cameron Fee in the June 2019 *ABI Journal*.

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Delaware District Court's Decision Highlights Potential Pitfall for Intercreditor Agreements

As the enforcement of intercreditor agreements (ICAs) between secured creditors plays an increasingly prominent role in bankruptcy cases, a recent ruling by the U.S. District Court for the District of Delaware suggests that the terms utilized in these agreements can have a significant impact on competing creditors' rights.

In September 2019, in *In re La Paloma Generating Company*, the U.S. District Court for the District of Delaware affirmed a Delaware bankruptcy court's interpretation and enforcement of an ICA. The case involved a dispute between a first-lien creditor and second-lien creditors over Chapter 11 plan distributions, which the collateral agent was holding in reserve to be distributed in accordance with the ICA. The ICA set forth the creditors' rights with respect to the "Collateral," which included substantially all of the debtors' assets.

The bankruptcy court granted the first-lien creditor's motion, finding that the ICA required the subject funds to be paid to the first-lien creditor. The bankruptcy court interpreted the ICA to require the second-lien creditors to return to the collateral agent any "Collateral or proceeds thereof" if four conditions were met: (i) the distribution is "Collateral or proceeds thereof"; (ii) the distribution is received "in connection with the exercise of any right or remedy" by the second-lien creditors; (iii) any such exercise of a right or remedy "relat[es] to the Collateral"; and (iv) the exercise of such right or remedy is in contravention of the ICA.

The district court affirmed the bankruptcy court's conclusion that all four elements of the turnover provision were satisfied. Notably, in analyzing the second element, the court found that the second-lien creditors' filing of a proof of a claim was an exercise of remedies, largely because the right to file a proof of claim was an action permitted in the exercise-of-remedies section of the ICA. (Interestingly, the bankruptcy court distinguished a prior Delaware case, *In re Energy Future Holdings, et al.*, which concluded that filing a proof of claim was not an exercise of remedies because, unlike the *La Paloma* ICA, the exercise-of-remedies section of that ICA did not include a safe harbor permitting the junior creditors to file a proof of claim.) Once the bankruptcy court determined that the elements of the turnover provision were satisfied, it applied the ICA's waterfall provisions and concluded that the first-lien lender should be paid in full prior to the second-lien creditors receiving a distribution.

The *La Paloma* decision is noteworthy in two respects: First, the district court affirmed that the junior creditors' filing of a proof of claim against the debtors, an action permitted under the ICA, constituted an "exercise of remedies" with respect to "Collateral." Second, the court affirmed, at least on the facts before it, that the lien subordination and turnover provisions provided for the "functional equivalent" of claim subordination. In short, the second-lien lenders' recoveries on account of their proof of claim were subject to the ICA's turnover provisions.

The district court further agreed with the first-lien lender that, having found that the plan distribution in question constituted proceeds of "Collateral," the distinction between claim and lien subordination was "nothing more than semantics." Specifically, the lien subordination and turnover provisions in the ICA were the "functional equivalent" of claim subordination given the bankruptcy court's finding that all remaining distributable assets constituted Collateral.

As the *La Paloma* decision makes clear, however, the terms used in ICAs can have a significant impact on a creditor's rights. Parties should carefully examine their ICAs with counsel, including to determine whether seemingly ordinary actions, such as filing a proof of claim, may be considered an "exercise of remedies" and therefore implicate turnover provisions of the ICA. The *La Paloma* decision is currently being appealed to the U.S. Court of Appeals for the Third Circuit, but the language of the current opinion could prove beneficial to first-lien creditors in future disputes and serves as a reminder to secured creditors to carefully review and understand their ICAs.

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Backstop Agreements Remain Common Source of Contention in Large Corporate Bankruptcies

In recent years, backstop agreements for rights offerings have emerged as an area of dispute in a number of large bankruptcy cases, and the trend appears likely to continue in 2020 and beyond.

A rights offering is a vehicle that allows debtors to raise money by offering debt or equity securities for sale, usually for a discounted price. Backstop agreements almost always accompany rights offerings in large bankruptcy cases. The creditors who agree to a backstop commit to purchase any remaining securities if the rights offering is undersubscribed. This ensures the debtor raises a specific amount of money. In exchange for this backstop commitment, the purchaser is paid a premium, usually in cash or additional securities.

In recent years, backstops have been attacked for allowing some creditors to receive higher recoveries than others with the same priority claims (in some cases even resulting in different recoveries for different holders of the same bonds). Objectors have tried to argue, among other things, that this disparate treatment violates the equal treatment requirements of Section 1123(a)(4) of the Bankruptcy Code.

Courts generally have taken a dim view of these objections. As long as the consideration received is for "new value" (*i.e.*, the backstop commitment), courts have repeatedly rejected the argument that a backstop premium paid to certain creditors violates the Bankruptcy Code. This was the approach in several large bankruptcies in recent years, including CHC Group, SunEdison and BreitBurn Energy Partners.

In August 2019, the U.S. Court of Appeals for the Eighth Circuit issued the strongest decision yet in support of paying a premium to existing creditors in exchange for a backstop commitment. In *In re Peabody Energy Corp.*, a group of creditors received significant consideration to backstop a $750 million rights offering and a $750 million private placement. Another group of creditors objected, arguing the lucrative backstop consideration for some creditors and not others resulted in unequal treatment. The Eighth Circuit soundly rejected this argument. Focusing on the high degree of volatility in coal prices, the Eighth Circuit agreed with both the bankruptcy court and the district court that (i) a backstop was necessary to ensure the debtors raised enough capital to fund their exit from bankruptcy and (ii) the consideration received by backstopping creditors was on account of the valuable backstop commitment and not the creditors' claims.

While the Eighth Circuit decision is likely a boon for creditors looking to improve their recoveries by participating in a backstop, a much less-noticed bench ruling by Judge Michael Wiles of the U.S. Bankruptcy Court for the Southern District of New York could provide a roadmap for those looking to successfully object to backstop agreements in the future. In *In re Pacific Drilling S.A.*, decided at the end of 2018, Judge Wiles approved a backstop agreement, but he did so with "a great deal of misgivings" and laid out a lengthy and articulate critique of backstop premiums. While Judge Wiles' ruling deserves to be read in full, a key takeaway is that debtors need to carefully explore all opportunities to raise capital and submit convincing evidence that a backstop commitment is (i) necessary, (ii) the best available alternative, and (iii) consistent with precedent transactions (both in and out of bankruptcy).

In a world flush with cash and with limited distressed investment opportunities, creditors will continue to push for aggressive and lucrative backstop agreements as a way to improve their recoveries. In that environment, even with the favorable ruling from the Eighth Circuit in the *Peabody* case, expect continued attacks on these lucrative arrangements, and don't be surprised if Judge Wiles' reasoning is used in support of future objections.

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Nonconsensual Third-Party Releases Remain an Option in the Third Circuit

In December 2019, the U.S. Court of Appeals for the Third Circuit issued its long-awaited decision in *In re Millennium Lab Holdings II, LLC*, affirming Delaware district court and bankruptcy court rulings that approved a Chapter 11 plan with nonconsensual third-party releases, which had been challenged at the confirmation hearing. The ruling should provide parties litigating bankruptcy plan confirmations in the Third Circuit confidence regarding the availability of nonconsensual releases.

The contested plan provisions in *Millennium* released claims against the debtors' former shareholders, who had received a $1.3 billion special dividend from the debtors approximately 18 months prior to the commencement of the bankruptcy proceedings. The released shareholders contributed $325 million to fund the debtors' Chapter 11 plan. The funds were utilized, in part, to pay for the debtors' $256 million settlement with several governmental agencies that were investigating the debtors and had threatened to revoke Medicare billing privileges that were essential to their business. A detailed evidentiary record established that the debtors could not afford to make the settlement payment without the shareholders' contribution and that, absent the government settlement, "liquidation, not reorganization, would have been Millennium's sole option."

The primary legal issue before the Third Circuit was whether the bankruptcy court, as a non-Article III court operating as a unit of the federal district court, had the requisite constitutional authority to confirm a Chapter 11 plan containing nonconsensual third-party releases and injunctions. Analyzing U.S. Supreme Court precedent, including the 2011 decision in *Stern v. Marshal*, the Third Circuit held that on "the specific exceptional facts of [the case,] the Bankruptcy Court was permitted to confirm the plan because the existence of the releases and injunctions was 'integral to the restructuring of the debtor-creditor relationship.'" The phrase "integral to the restructuring of the debtor-creditor relationship" appears likely to remain a critical focus, in the Third Circuit and beyond, of future decisions analyzing the boundaries of a bankruptcy court's authority under the Constitution.

In addition to establishing that the bankruptcy court has the authority necessary to approve these types of Chapter 11 plans, the *Millennium* decision also confirms that nonconsensual third-party releases are, indeed, acceptable to courts and available to debtors in the Third Circuit under appropriate circumstances. While the majority view in the Third Circuit has supported the availability of nonconsensual third-party releases ever since the court's seminal decision in *In re Continental Airlines, Inc.* in 2000, some litigants (and at least one lower court in the Third Circuit) have argued that *Continental* left the question unanswered.

In *Millennium*, the Third Circuit discusses *Continental* and another of its past rulings implicating plan injunctions, its 2011 decision in *In re Global Industrial Technologies, Inc.*, in a manner that should leave no doubt about the current state of Third Circuit law. The court's decision confirms that nonconsensual third-party releases remain a potential option. Distressed companies and their management teams, shareholders, lenders and other key stakeholders involved in complex restructuring efforts should be confident that bankruptcy courts in the Third Circuit, including the District of Delaware, offer the full array of tools and options often required to achieve and implement a truly global restructuring.

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