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Chapter 11 Under Fire: U.S. Congress Seeks to End Forum Shopping

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Since its beginning in 1978, Chapter 11 has been the primary tool for financially distressed U.S. and foreign companies to efficiently restructure their balance sheets and business operations. Successful Chapter 11 cases have allowed prominent financially distressed companies to reorganize, or pursue going concern asset sales, adding economic value to the global economy. This includes Lehman Brothers, General Motors, Enron, MF Global, Chrysler, Texaco, US Steel, American Airlines, Delta, United, and the list goes on.

Key Bankruptcy Code concepts include an injunction against creditor action (automatic stay), efficient resolution of key contracts with third parties (executory contracts), fast sales of assets free and clear of liens (Section 363 sale), clear rules on priority of payment of creditors (absolute priority rule), the ability to bind dissenting creditors to a restructuring plan (cram down), and a fresh start for restructured companies (discharge of pre-filing debts).

Chapter 11 has become an integral part of the U.S. and global economy and become highly regarded and often a guide for other countries' insolvency laws.

Despite its "success" as a strategic business tool, Chapter 11 has come under scrutiny lately as corrupted by intense "judge shopping". For sure, since its inception, a significant number of Chapter 11 cases, especially mega cases, have been filed in the federal Southern District of New York (SDNY) and Delaware, given those jurisdictions' respective "financial center" expertise and the corporate domicile for corporations. Currently Delaware has 9 bankruptcy judges to handle its case load, and the SDNY has 9 bankruptcy court judges.

Recently Texas, particularly Houston, has also become a Chapter 11 "hotspot" as well.

On July 28, 2021, Georgetown Law School Professor Adam Levitin testified before the Committee on the Judiciary Subcommittee on Antitrust, Commercial, and Administrative Law United States House of Representatives. The topic was: "Oversight of the Bankruptcy Code, Part I: Confronting Abuses of the Chapter 11 System."

In This Issue

Professor Levitin notes that 57% of large public company Chapter 11 cases in 2020 were heard by 3 out of 375 U.S. bankruptcy judges, Judge Robert Drain of the Southern District of New York, and Judges David Jones and Marvin Isgur both of the Southern District of Texas. Judge Jones presided over 39% of all U.S. mega cases in 2020. We in fact have been involved in several significant Chapter 11 cases in 2020/2021 in the Southern District of Texas, including Neiman Marcus, McDermott International (Chicago Bridge & Iron), Technicolor and Dean Foods (25+ household name dairy brands). In essence, Professor Levitin's thesis is that judge shopping has allowed debtors to game the system to the disadvantage of the Chapter 11 process and creditors.

The judge shopping is clearly intentional, based upon case assignment procedures in various bankruptcy courts. In the SDNY, there are 8 judges in Manhattan and 1 in White Plains, Judge Robert Drain, who presided over the Purdue Pharma (opioid) Chapter 11 case. Purdue Pharma did not file Chapter 11 in Connecticut where it is headquartered, or in Delaware where it is incorporated. Rather, Purdue Pharma changed its service of process address to be assigned to the White Plains division of the SDNY. Why did Purdue Pharma want Judge Drain as its judge? According to Professor Levitin's testimony, it is because of the belief that Judge Drain would be inclined to approve a Plan of Reorganization that included broad releases imposed on creditors of non-debtor related parties, including

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the Sackler family who controlled Purdue Pharma. In fact, on September 17, 2021, Judge Drain confirmed the Purdue Pharma Plan of Reorganization, which released the Sacklers of all liability. On December 16, 2021, the U.S. District Court for the Southern District of New York vacated the Confirmation Order due to the Sackers' releases. On January 18, 2022, Purdue Pharma appealed the U.S. District Court decision to the U.S. 2nd Circuit Court of Appeals.

Professor Levitin's written testimony included the following excerpts about the Purdue Pharma case:

> *In a couple of weeks, a bankruptcy court in White Plains, New York, will hold a hearing to confirm the chapter 11 reorganization plan of Purdue Pharma, the manufacturer of OxyContin, a highly addictive opioid. Purdue is a closely held company owned by the immensely wealthy Sackler family, whose names grace major museums. The Sacklers functioned, according to the Department of Justice, Purdue's "de facto CEO." The Sacklers also received as much as $13 billion in dividends and other payments from Purdue over the years, including after Purdue's contribution to the opioid crisis became clear.*
>
> *Purdue has proposed funding its plan primarily through a $4.275 billion contribution from the Sackler family, to be paid out over ten years. The Sacklers agreed to this contribution in exchange for a release not only of Purdue's claims against them, but also for a release of any claims Purdue's creditors--that is opioid victims--have against them.*
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> *If Purdue's plan is approved, the Sacklers—who have never filed for bankruptcy—will get the equivalent of a discharge of their liabilities related to the opioid crisis. What's more, the release of the Sacklers bind all of Purdue's creditors, regardless of their consent.*
>
> *In short, the Sacklers will get the benefits of bankruptcy without having to go through the bankruptcy crucible. They will not have to make public disclosure of the finances under penalty of criminal law. They will not have to surrender control of their assets to an independent trustee. And they will not have to surrender all of their wealth to their creditors other than the minimal assets exempted by the Bankruptcy Code.*
>
> *To the contrary, the Sacklers will walk away from Purdue—and the misery of the opioid crisis—billionaires several times over. Their precise wealth is unknown, but the payments they will make to opioid victims do not even amount to the interest they would otherwise earn over the next ten years on the funds they took out of Purdue. And, the Sacklers will likely seek to take a $4.275 billion tax deduction for their contribution to the Purdue bankruptcy plan. In other words, the Sacklers will emerge from their Purdue bankruptcy settlement even richer than when they went into it.*

Professor Levitin further posits that there are a handful of U.S. bankruptcy judges who are "eager" to attract Chapter 11 mega cases, and must compete to get them.

> *Once debtor's counsel (and other case placers) perceive that a judge (or district) wants to land big cases, that tells them all that they need to know: the only way a judge can be sure to continue to attract such large cases is to rule in the debtor's favor on all major issues and to be accommodating to the debtor's counsel on matters such as scheduling and fee approval. A judge that fails to do that becomes known as "unpredictable" and will be unable to attract large cases. To be clear: these judges surely believe that they are doing their level best to just call balls and strikes in their cases, but if they disappoint debtor's counsel, business will go elsewhere.*
>
> *Lest this sound abstract, consider the relationship between bankruptcy powerhouse "BigLaw" (actual name deleted for this article) and the Delaware bankruptcy court. In the years prior to 2017, BigLaw had previously regularly filed 3-4 large cases in Delaware annually, never going more than a few months without filing a case. Delaware got over have (sic) of BigLaw filings in these years. BigLaw, however, ran into trouble in its representation of (particular Chapter 11 debtor, name deleted) in Delaware. First, the bankruptcy judge said that he was "furious" regarding the terms on which lenders consented to let the debtor use their collateral during the bankruptcy. Next, the judge denied a fee application for hours BigLaw billed defending its own services. And then in (date deleted), the judge exploded in court at BigLaw attorneys for pulling a sharp move on a pro se creditor in the case: "You can't treat these people like this. I will not allow it. I will shut this whole F'ing case down prior to this. Get out of your own way. I need a recess."*
>
> *After this incident, BigLaw withdrew its business from Delaware: 327 days elapsed before BigLaw's next Delaware filing, resulting in an unprecedented gap of 616 days between BigLaw filings in Delaware. During this time, BigLaw filed 14 megacases filed in other venues, particularly Houston, New York, and Richmond. The message was clear—give us grief, and we'll take our business elsewhere.*

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What are Other Advantages of the "Right" Judge?

In addition to broad releases of non-debtor insiders in Plans of Reorganization, what else are debtors after in terms of favorable rulings?

1. <u>Evasion of the Plan Confirmation Process</u>. Frequently in Chapter 11 cases, in the first few days or weeks of filing, the Bankruptcy Court approves motions for post-petition financing, restructuring support agreements (RSAs), Section 363 sales of all assets free and clear of liens or assumption of "consulting agreements" for all-out liquidation sales.

Transactions that aim to end-run safeguards of the plan process are considered "sub rosa plans" which effectively determine the outcome for all creditor constituents within the first few days or weeks of the case. The early court approval evades the requirements and safeguards for the creditor constituencies imbedded in the Chapter 11 plan of reorganization process. For example, Chapter 11 requires as a condition of Plan Confirmation that all administrative claims (including for the post-filing sale of goods and services and Section 503(b)(9) claim) be paid in full at confirmation. This requirement can be compromised by "sub rosa plans."

2. <u>"Payday before Mayday".</u>

Those who control companies that file Chapter 11 frequently seek extraordinary compensation as incentive to retain them. In 2005, the U.S. Congress amended the Bankruptcy Code to limit this practice, but left a loophole for payment. Professor Levitin's written testimony on this issue:

> *Bankrupt companies often face challenges retaining talent: it can be demoralizing to work for a bankruptcy company; the company's future is uncertain; the bankruptcy process can be a hassle or a distraction. The Bankruptcy Code, however, makes it exceedingly difficult to offer retention bonuses to "insiders," a group that includes the debtor's officers and directors. While the term "officer" is not defined, it undoubtedly covers all C-suite executives with "officer" in their titles.*
>
> *The Code prohibits retention payments unless the court finds that (1) the insider's services are essential to the survival of the debtor; (2) the executive has a bona fide job offer at another business at the same or greater rate of compensation; and (3) that the payment is no more than 10x the amount of the average retention bonus paid to nonmanagement employees in that year. As a result of these restrictions, no debtor has even attempted, to the best of my knowledge, to make a post-bankruptcy retention payment to an insider. In order to do so, the debtor would have to require the officer or director to obtain an equal or better job offer, something no debtor would want to do.*
>
> *While debtors have instituted key employee retention programs (KERPs) for non-insider executives, the only way to compensate C-suite executives and directors for sticking around with the bankruptcy company is through key employee incentive programs (KEIPs). Whereas a KERP pays the employee simply for remaining employed, a KEIP pays the employee upon the achievement of certain performance goals. If the goals are set too low, however, a KEIP can function as a disguised KERP.*
>
> *Rather than deal with KEIPs, however, debtors have increasingly turned to making payments to insiders on the eve of bankruptcy. While unseemly, this practice is currently perfectly legal; the Bankruptcy Code does not apply until the debtor files for bankruptcy.*

As countries around the globe seek to modify and modernize their insolvency laws, Professor Levitin's observations and proposed amendments to Chapter 11's Bankruptcy Code are instructive. Despite these issues, Chapter 11 has been and continues to be an excellent strategic tool and forum to restructure and preserve economic enterprises which adds untold value to the global economy. In fact, Chapter 11 channels virtually all issues dealing with the companies' balance sheets, capital structures, debt structures, major contracts, employment related issues, taxes and more into a uniquely efficient and singular forum. Yet, it is prudent for the U.S. Congress to consider Professor Levitin's recommended amendments to the Bankruptcy Code. After all, since 1978 the global economy, its industries and companies and how they are capitalized and funded have become significantly more complex, diverse and, as Lehman Brothers demonstrated, more globally interwoven.

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Largely in response to the Purdue Pharma case, on September 23, 2021, Senators Warren (D-MA) and Cornyn (R-Texas) introduced the bipartisan Bankruptcy Venue Reform Act of 2021, which requires big businesses and wealthy individuals to file bankruptcy in their home states or where their largest assets are located. On September 28, 2021, the U.S. Bankruptcy Court for the Southern District of New York announced that Judge Drain would retire effective June 30, 2022.

In connection with the Chapter 11 case of Mahwah Bergen Retail Group, Inc., on January 13, 2022, the U.S. District for the Eastern District of Virginia voided the Bankruptcy Court Order confirming the Debtors Plan of Reorganization that included third-party releases. In so ruling, the U.S. District Court stated:

> *… the Bankruptcy Court for the Richmond Division of this district regularly approves third-party releases, as acknowledged by Debtors' counsel during oral argument. (Tr. Of Dec. 20, 2021 Argument ("Arg. Tr.") at 6:8-14 (ECF No. 75).) This recurrent practice contributes to major companies like Mahwah (a New Jersey company) using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here. Indeed, according to the Trustee, the Richmond Division (just the division, not the entire Eastern District of Virginia) joins the District of Delaware, the Southern District of New York, and the Houston Division of the Southern District of Texas as the venue choice for 91% of the "mega" bankruptcy cases. (Reply Br. Of Appellant John P. Fitzgerald, III, Acting United States Trustee for Region 4 ("Trustee Reply Br.") at 22-23 (ECF No. 45).) The ubiquity of third-party releases in the Richmond Division demands even greater scrutiny of the propriety of such releases. And, their prevalence also undermines assertions that they are integral to the success of this particular reorganization plan. As District Judge Colleen McMahon astutely observed: "When every case is unique, none is unique." In re Purdue Pharma, L.P., 2021 WL 5979108, at *3.*

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David's experience, business acumen and creativity adds value for clients regarding a variety of issues involving corporate bankruptcy, insolvency and restructuring; commercial contracts and business transactions; commercial disputes; and cross-border transactions, disputes and insolvencies.

David is particularly strong representing manufacturing companies, from middle market to large multinational companies in the U.S. and abroad, across many industries including agrichemicals and seeds, aluminum and glass containers and packaging, appliances, automotive, chemicals, energy, food packaging, forest products, furniture, machinery and equipment, paper and packaging, plastics and resins, steel and metals, and textiles. David has broad experience in handling commercial matters with customers, vendors, and the supply chain.

David has been involved in many of the largest insolvency cases in the U.S. and abroad including representing unsecured creditors' committees, suppliers to or customers of distressed companies, financial institutions, private equity or portfolio companies, boards of directors, counter-parties to contracts and buyers of distressed assets.

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