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Client Alert: Chapter 11 Trends: Are First Day Hearings "Game Over" for Chapter 11 Cases?

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David H. Conaway

MEDIA CONTACT

Wendy M. Byrne
wbyrne@shumaker.com

Material Chapter 11 cases have morphed to the point that the outcome is often predetermined at the "first day" hearing. Unsecured creditors with material credit exposure should engage early to protect their interests and reduce risk of loss.

Bankruptcy Courts generally approve motions that are presented for "first day" hearings, especially if supported by lenders and other capital markets participants, deferring to the business judgment of management. The court orders entered on the first day almost always compromise rights of unsecured creditors. Knowing the law is not enough; a creditor must also understand the dynamics of modern Chapter 11 practice and understand the key jurisdictions where significant cases are occurring.

Chapter 11 is Pure Capitalism

Chapter 11 has proven to be a forum for a number of business transactions, including mergers and acquisitions, sales of asset, financial restructurings, and debt financings. Increasingly, these transactions are being played out at "First Day" Chapter 11 hearings, not in the Plan of Reorganization that requires voting of all impaired creditor constituents. As "First Day" hearings occur within 24-48 hours of a Chapter 11 filing, there is virtually no due process to creditors who have not been involved in the pre-Chapter 11 negotiations. There is no "vote" for debtor-in-possession (DIP) financing at a First Day hearing. A creditor's recourse is filing an objection based on rights and protections set forth in the Bankruptcy Code and under applicable law.

For example, in a "pre-packaged" Chapter 11 case, prior to the Chapter 11 filing, the debtor has negotiated a number of key terms, including DIP financing, exit financing, treatment of the lenders' claims, treatment of other financial debt such as noteholders that are junior to the lender (often a debt for equity swap), and treatment of general unsecured claims. The terms are normally set forth in a "restructuring support agreement" with the financial creditors. Other creditors such as landlords and trade suppliers are not parties to the restructuring support agreement.

The Bankruptcy Code provides that a motion to approve DIP financing be served on the largest unsecured creditors with 14 days' notice of a final hearing. A Section 363 sale of all assets requires 21 days' notice to all creditors, with an opportunity for objection and a hearing before the court. This notice can be shortened "for cause." Likewise, the Bankruptcy Code requires 28 days' notice to all creditors of the hearing to approve a Plan of Reorganization, as well as the time fixed to file objections to the Plan.

These notice requirements contained in the Federal Rules of Bankruptcy Procedure are the standard "due process" that the Supreme Court determined appropriate for Chapter 11 cases by balancing various stakeholders' interests and the urgency of Chapter 11 proceedings.

However, the trend in Chapter 11 cases is for their outcome to be negotiated prior to filing and approved within 48 hours of filing. Below are examples of pre-petition negotiations and first-day filings impacting creditors who were not at the table.

<u>First Day Sale of the Reorganized Debtor's Equity</u>

In the U.S. Chapter 11 case of SAS AB (Scandinavian Airlines) in the Southern District of New York, U.S.-based Apollo Group Management agreed to provide SAS $700 million in DIP financing, approved by the court on August 31, 2022, at per annum interest of SOFR + 9%, and a break-up fee of 1% ($7 million). Also, the DIP provides Apollo a Call Option to subscribe for equity in the reorganized debtors based on an enterprise value of $3.2 billion. It is projected that Apollo will ultimately own 22%-30% of SAS. Apollo and Denmark will collectively own approximately 50% of SAS.

Though not novel, the Apollo DIP transaction demonstrates the incredible versatility of Chapter 11 as a forum to not only restructure, but to also facilitate an acquisition, essentially in one transaction. The equity lenders receive all of the super-priority administrative claims, fees, controls, protections, and other perks of DIP lending for an option to be a significant equity owner of the reorganized debtors. Sometimes, the only value unsecured creditors receive in Chapter 11 is a pro rata share of the equity in the reorganized debtor. In approving the SAS DIP financing for lack of any objection, the Bankruptcy Court raised concerns of a troubling trend.

<u>First Day Prepackaged Plan Splits Unsecured Creditors in Two</u>

Despite Chapter 11's time-honored requirement that all similarly situated creditors (e.g., the class of unsecured creditors) must be treated the same, the prepackaged plan filed by Serta Simmons Bedding, LLC (2/22/23, S.D. Texas) provides for disparate treatment of unsecured creditors. The Serta Simmons plan proposes that:

1. Unsecured creditors who vote for the plan AND execute a trade agreement obligating the creditor to continue to sell goods or services on the same or better terms as provided in the 6 months prior to filing Chapter 11 will be paid 100%.
2. Other unsecured creditors will receive their pro rata share of $1 million on an estimated $30 million of unsecured claims, or 3%.

Serta Simmons' plan essentially replaces the equal treatment of all unsecured creditors with a critical vendor standard. This clearly violates the Bankruptcy Code and is certainly objectionable, but if the unsecured creditors' committee or other creditors do not object, the plan will be approved. And, a new Chapter 11 "trend" is born. Though not a reported legal ruling, this Serta Simmons strategy would be cited in future Chapter 11 cases as the "norm".

<u>U.S. Mass Tort Litigation System Side-Stepped by Texas Two-Step?</u>

The Mass Tort Litigation System in the U.S. is not pristine. It is perhaps, riddled with mixed motivations and massive contingency fees. Though, in cases such as Johnson & Johnson (Baby Powder Talc), Purdue Pharma (Opioids), and Boy Scouts of America (sexual abuse claims), not to mention tobacco and asbestos cases, parties who have valid damage claims should have their day in court.

Johnson & Johnson developed a workaround to its mass tort litigation claims. In what has been labeled the "Texas Two-Step," Johnson & Johnson engineered a "divisive merger" under Texas corporate law, which allows a corporation to create a new entity and transfer liabilities to the newco and retain the assets in an affiliate company, in this case to "new" Johnson & Johnson. Johnson & Johnson formed LTL Management LLC, transferred the talc litigation claims to LTL, and then caused it to file Chapter 11 in Bankruptcy Court in the Western District of North Carolina (Charlotte), later transferred to New Jersey. The purpose of the Chapter 11 filing was to invoke the Chapter 11 injunction of all pre-filing litigation cases under the Bankruptcy Code Section 362 "automatic stay." Any LTL plan of liquidation would also provide broad releases to any and all affiliates, officers, directors, employees, lenders, advisors, etc.

Presumably, in Chapter 11, LTL/Johnson & Johnson would better control settlement of the talc claims. Indeed, Bankruptcy Code Section 524(g) allows a debtor to "channel" certain classes of claims to a trust established by a plan of liquidation for future claims. In fact, Johnson & Johnson had a "back stop" funding agreement with LTL for $61.5 billion. In essence, Johnson & Johnson unilaterally set the settlement amount for claims.

In Johnson & Johnson, the tort claimants moved to dismiss the LTL Chapter 11 case as a "bad faith" filing, on the grounds that LTL was not financially distressed or insolvent. The Bankruptcy Court denied the motion to dismiss. However, on January 30, 2023, the U.S. 3rd Circuit Court of Appeals dismissed the LTL Chapter 11 case as a "bad faith" filing due primarily to the $61.5 billion "back stop" agreement between Johnson & Johnson and LTL. On April 4, 2023, LTL re-filed Chapter 11, that provides for LTL and Johnson & Johnson to pay talc claimants $8.9 billion over 25 years. The deal is supported by plaintiff law firms representing over 60,000 current talc claimants.

In the Purdue Pharma case, the Sackler family provided $4.5 billion to an opioid trust fund in exchange for broad releases. Though the Purdue Pharma Plan of Reorganization, which included broad releases of the Sackler family, was approved by the Bankruptcy Court, the plan was later overturned by the U.S. 2nd Circuit Court of Appeals. Ultimately, the matter was settled by the Sackler family increasing the contribution to the opioid claim trust to $6 billion, to obtain approval of Purdue Pharma's Chapter 11 plan.

What is the answer? How should mass tort claims be resolved? The U.S. Mass Tort Litigation System may not be the best answer. But, companies who have caused damage should not be able to unilaterally set the settlement price or shield their officers, directors, or shareholders from potential claims. Chapter 11 very well may be a nimble and a comparatively cost-effective forum to resolve mass tort claims. Perhaps the Bankruptcy Code could be amended to provide for a neutral and robust claims valuation procedure.

It is doubtful the Texas Two-Step will go the way of Gangnam Style, but it will persist with permutations.

<u>First Day Orders Eliminate Vendors' Uniform Commercial Code State Law Rights</u>

The Uniform Commercial Code (UCC) has been adopted, more or less identically, by virtually every U.S. state. Functionally, the UCC is "federal" law. Regarding the sale of goods, vendors with sales contracts with distressed customers have two powerful remedies.

Under UCC 2-609, a vendor with reasonable grounds of insecurity about its customer's ability to pay in the future, may suspend its performance and demand from its customer reasonable assurances of future performance, which must be given within 30 days. Failure of such assurances allows the vendor to declare the contract breached with no further performance obligation. In the case of an insolvent Chapter 11 debtor, relief from future performance will minimize risk of loss.

Similarly, UCC 2-702 allows a vendor to change its payment terms to cash in advance if it learns of its customer's insolvency.

In Chapter 11 cases, debtors almost always cite Section 365(e)(1) of the Bankruptcy Code, which provides:

> … an executory contract (which includes a sales contract) may not be terminated or modified solely based on a contract term regarding the insolvency or financial condition of the debtor or the commencement of a Chapter 11.

Debtors seize on this provision to assert that vendors with contracts must continue to ship goods and provide credit terms, regardless of the credit risk.

However, debtors routinely choose to ignore Section 365(e)(2)(A), which provides an exception to the above provision if "applicable law" excuses a party from rendering performance. UCC 2-609 and 2-702 are that "applicable law."

In virtually every material Chapter 11 case, debtors obtain a first day order that provides no party may terminate or modify an executory contract. Period. Unless a creditor objects to the first day motion, there will be a Bankruptcy Court order eliminating a vendor's rights under UCC 2-609 and 2-702.

<u>Conclusion</u>

You gotta love Chapter 11 … it is a dynamic forum where virtually all legal and financing issues are addressed with incredible creativity and freedom of contract. Chapter 11 may be the purest example of capitalism. Depending on the Bankruptcy Court, it may also be completely unregulated. Yet, Chapter 11 is the ultimate zero-sum game as debtors' asset values are usually below their liabilities. In pursuing their interests as existing or potential financiers of distressed companies, capital markets participants have created a variety of creative financial strategies. Perhaps this highlights the need for the Bankruptcy Court judiciary to protect the Bankruptcy Code and its policies as well as ensure more than nominal due process for all stakeholders.

In the constantly evolving Chapter 11 environment, vendors with material exposure must engage early to minimize risk.

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