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Bankruptcy Litigation

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CONCURRENT SESSION

2017

ABI/NYC BANKRUPTCY CONFERENCE

BANKRUPTCY LITIGATION

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Feasibility Requirements

I. Statute:

a. Section 1129(a)(11) provides that a plan is confirmable, if, *inter alia*, "[c]onfirmation of the plan is not likely to be followed by liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." *See* 11 U.S.C. § 1129(a)(11).

b. A debtor must prove a chapter 11 plan's feasibility by a preponderance of the evidence. *In re T-H New Orleans Ltd., P'Ship*, 116 F.3d 790, 801 (5th Cir. 1997). Section "1129(a)(11) does not require a guarantee of the plan's success; rather the proper standard is whether the plan offers a 'reasonable assurance' of success." *In re Indianapolis Downs*, 486 B.R. 286, 298 (Bankr. D. Del. 2013).

II. Factors:

a. Courts have considered various factors in assessing the feasibility of a plan of reorganization, including:

i. The adequacy of the debtor's capital structure;
ii. The earning power of its business'
iii. Economic conditions;
iv. The ability of the debtor's management;
v. The probability of the continuation of the same management; and
vi. Any other related matters which determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan. *See In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 226-27 (Bankr. D.N.J. 2000).

b. The "Debtors are not required to view [their] business and economic prospects in the worst possible light." *See In re Am. Consol. Transp. Companies, Inc.*, 470 B.R. 478, 491 (Bankr. N.D. Ill. 2012).

c. Rather, "[w]here the projections are credible, based upon the balancing of all testimony, evidence, and documentation, even if the projections are aggressive, the court may find the plan feasible." *See In re T-H New Orleans, Ltd., P'Ship*, 116 F.3d at 802.

III. ***In re Paragon Offshore, PLC*, Case No. 16-10386 (CSS), 2016 WL 6699318 (Bankr. D. Del. Nov. 15, 2016)**:

a. **Issue**: the issue before the Court was whether the Debtor's plan of reorganization was feasible pursuant to section 1129(a)(11) of the Bankruptcy Code.

b. **Holding**: The Court held that the debtors' plan was not feasible pursuant to section 1129(a)(11) of the Bankruptcy Code because: (1) the assumption underlying the Debtors Downside Sensitivity and the Modified Cash Base were not reasonably achievable, the Debtors are likely to run out of cash and be unable to pay their debts; and (2) the Debtors are unlikely able to refinance their indebtedness to the Term Lenders, the Revolver Lenders, and the Noteholders at or prior to maturity.

c. **Facts**:

i. **Debtors' Prepetition Indebtedness**:

1. On the Petition Date, the Debtors had $1.43 billion of secured indebtedness.

a. Paragon Parent and Paragon International Finance Company are borrowers under a Senior Secured Revolving Credit Agreement, dated as of June 17, 2014, by and among Paragon Parent and Paragon International Finance Company, as borrowers, the lenders and issuing banks party thereto (the "**Revolving Lenders**") from time to time JP Morgan Chase, N.A., as administrative agent, J.P. Morgan Securities, LLC, Deutsche Bank Securities, Inc. and Barclays Bank plc, as Joint Lead Arrangers and Joint Lead Bookrunners, (the "**Revolving Credit Agreement**"). The Revolving Credit Facility provides for revolving credit commitments in an aggregate amount of $800 million (the "**Revolving Credit Facility**", and the amounts thereunder, the "**Loans**"). As of the Petition Date, the aggregate amount owed under the Revolving Credit Agreement was $708 million.

b. Paragon Offshore Finance Company is the borrower under a Senior Secured Term Loan Agreement, dated as of July 18, 2014, by and among Paragon Parent, as parent, Paragon Offshore Finance Company, as borrower, the lender parties thereto, and Cortland Capital Market Services, LLC, as successor administrative agent, (the "**Term Loan Agent**") as amended, (the "**Secured Term Loan Agreement**"). The Secured Term Loan Agreement provided for a term loan in the amount of $650 million (the "**Secured Term Loan**"). As of the Petition Date, $642 million remained outstanding under the Secured Term Loan.

2. On the Petition Date, the Debtors had $1.02 billion in unsecured indebtedness.

a. Paragon Parent is a party to a Senior Notes Indenture, dated as of July 18, 2014, by and among Paragon Parent, as issuer, each of the guarantors and Deutsche Bank Trust Company Americas, as trustee (the "**Notes Trustee**"), pursuant to which the Debtors issued 6.75% Senior Notes due 2022 in the amount of $500 million (the "**6.75% Senior Notes**") and 7.25% Senior Notes due 2024 in the amount of $580 million (the "**7.25% Senior Notes**", together with the 6.75% Senior Notes, the **"Senior Notes**"). As of the Petition Date, $457 million remained owing on the 6.75% Senior Notes. As of the Petition Date, $527 million remained owing on the 7.25% Senior Notes.

ii. **Debtors' Business**:

1. The Debtors are a global provider of offshore drilling rigs. The Debtors operate in the North Sea, the Middle East and India. The Debtors operate standard specification rigs, which are used for "development drilling" on preexisting oil and gas fields. The rigs are also used for "workover" or fixing existing wells, as well as plugging and abandoning activities. Over the past 3 years, 80% of Paragon's business consisted of development drilling, workovers, re-entry and P&A work.

2. In addition, the Debtors also operate the rigs on behalf of customers in the oil and gas industry. The Debtors' customers include large national and international E&P companies, midsize E&P companies and smaller E&P companies.

3. Paragon's assets consist of 40 offshore drilling rigs. These consist of 34 jackup rigs and 6 floating rigs ("floaters" including 3 drillships and 2 semisubmersibles). The Debtors also have an inventory on capital spares, or spare equipment, before the spinoff from Noble (discussed later) and idle rigs that can also be used for parts in lieu of making capital expenditures.

4. Upon emergence from chapter 11 bankruptcy, the Debtors propose to reduce their fleet to 23 rigs, 22 jackups and one semisubmersible. Under the Downside Sensitivity analysis, the Debtors would operate 22 rigs.

5. Oil and gas prices and an oversupply of jackup rigs in the offshore industry, among other things, led to the Debtors' bankruptcy filing.

iii. **Debtors' Preparation of Downward Sensitivity**:

1. After the initial confirmation hearing, the Debtors prepared a downside sensitivity analysis to the Debtors' business plan (the "**Downside Sensitivity**"). The Downside Sensitivity is not a revised business plan of the Debtors, but contains more conservative inputs and is a "stress test" of Paragon's business plan that assumes a longer and more prolonged downturn and slower recovery.

2. The Downside sensitivity made significant adjustments to dayrates, utilization, and capital expenditures, including adding increased costs for rigs that were out of service longer. In contrast to the Debtors Modified Plan (discussed below), the Downside Sensitivity assumed that 17 of the Debtors' 23 rigs have dayrates reduced by 20% and that dayrates will start low and increase slowly. Further, the analysis assumed that the utilization assumptions were lower than the Debtors' business plan and remain lower for a longer period of time with a much slower recovery. Further, certain contracts would be cancelled and result in idle time in between rig contracts.

3. The Downside Sensitivity's revised assumptions result in $770 million less in projected revenue and $591 million less in aggregate EBITDA than the Debtors' business plan, reductions of 26% and 54% respectively.

4. Further, the amount of cash on hand under the Downside Sensitivity is $177 million cash at the end of projection period and $143 million in cash at the end of 2018.

iv. **Noble Settlement**:

1. The Debtors were spun-off from Noble Corporation plc ("**Noble**") in August 2014 (the "**Spinoff**"). Paragon and Noble are party to several separation agreements executed in the connection with the Spinoff including a tax sharing agreement dated as of July 31, 2014 (the "**Tax Sharing Agreement**"). The Tax Sharing Agreement provides that Paragon assumed responsibility for certain tax liabilities for certain Paragon entities and some of the Noble entities. Also, on July 21, 2016, the Debtors executed a side letter with Noble which modified the Tax Sharing Agreement to allow Noble to manage certain tax claims in Mexico. The Debtors were assessed with a tax liability (the "**Mexican Tax Liabilities**"). The Mexican Tax Liabilities were estimated to be $190 million, but could grow to $300 million.

2. The tax penalties can be settled for pennies on the dollar. However, during the pendency of a tax appeal, a bond for the full amount of the assessment must be posted. Thus, the Debtors would have to post a bond of $200 million and potentially up to $300 million as well as become liable for $45 million in fees in connection with posting the bond.

3. The Debtors and Noble executed a settlement term sheet in February 2016. The key terms of the settlement included the following: (i) Noble would assume more responsibility for the Mexican Tax Liabilities and (ii) provide the direct bonding for the Mexican Tax Liabilities, thereby permitting Noble and the Debtors to dispute the claims without requiring the Debtors to collateralize the bond, and as a result, freeing up $200 million of cash for the Debtors. In exchange, the Debtors agreed to waive any potential fraudulent conveyance claims against Noble.

v. **Modified Plan**:

1. The Debtors plan essentially deleveraged the Debtors' by eliminating $1 billion in debt, converting the Revolving Credit Facility into a term loan and extends its maturity by 2 years and reduces the Debtors' interest expense by half. The Debtors would emerge with $379 million in cash on hand.
2. The Noble settlement was negotiated and incorporated into the modified plan with Noble to receive reimbursements for amounts paid under the Noble Settlement Agreement with a $5 million note instead of cash.
3. Pursuant to the plan, only holders of class 3 claims (Revolving Credit Agreement claim) and class 5 claims (Senior Notes Claims) have the ability to vote. The remaining classes were not entitled to vote.
4. The Debtors have no EBITDA-based covenants until 2019 and covenants for 2019 and beyond were relaxed.
5. The amended and restated credit agreement was revised to reduce the minimum liquidity requirement from $110 million to $103 million.
6. The Senior Notes Claims were modified to: (i) reduce the cash payment to be provided to the holders of Senior Notes Claims from $345 million to $285 million; (ii) remove certain contingent payments from the package of consideration to the holders of Senior Notes Claims; and (iii) provide for the issuance $60 million unsecured New Notes; and (iv) increase the number of Parent Ordinary Shares to be issued to the holders of Senior Notes Claims from 35% to 47%.

d. **Court's Analysis**:

i. The capital expenditure assumptions were reasonable.

1. The court found that the capital expenditures were reasonable because the Debtors senior management and engineering group was credible; the Debtors removed discretionary capital expenditures; costs were lower than expected; and their estimates were conservative.

ii. The downside sensitivity is not achievable because the projected utilization and dayrates are not achievable and the debtor will run out of cash.

1. The overhang of rigs has put a downward pressure on current and future dayrates. Both the supply of rigs and the price of oil correlate with dayrates. If the market has an oversupply of rigs, dayrates fall. As oil prices fall, dayrates fall. Both rig utilization and oil prices were together to influence dayrates. The oversupply of jackup rigs and floaters may lead to reduction and in dayrates and demand for their rigs, which would adversely affect the profitability of the Debtors.
2. The Debtors' day rates are not achievable. The Debtors did not look at third party reports on the outlook of dayrates. The Court found that the Debtors did not review any analysis explaining how the supply overhang would disappear after 2017 causing dayrates to recover. Third party analyst reports suggests that there's no sustainable recovery in the near future.

iii. The utilization assumptions are too aggressive.
iv. The Debtors' would not be able to refinance their debt.
v. The Debtors will run out of cash and not be able to refinance their debts and breach their financial covenants.

e. **Events Post Decision Denying Confirmation**:

i. Court denied the request for an official equity committee on March 28, 2017 [dkt. no. 1297].
ii. The Debtors obtained approval of an amended disclosure statement on March 27, 2017 with a confirmation hearing scheduled for June 5, 2017 [dkt. no. 1293].

Schulte Roth&Zabel

Bankruptcy Litigation Update: Determining Adequate Capital

By David M. Hillman and Parker J. Milender[1]

Constructive fraudulent transfer statutes require a plaintiff to prove that the debtor made a transfer or incurred an obligation in exchange for less than reasonably equivalent value and (i) was insolvent on the date of the transfer or became insolvent thereby; (ii) "was engaged in business or a transaction, or was about to engage in a business or transaction, for which any property remaining with the debtor was an unreasonably small capital" or (iii) intended to incur, or believed that it would incur, debts that would be beyond the transferee's ability to pay as they matured." *See* 11 U.S.C. § 548(a)(1)(B).[2] The issues of insolvency, unreasonably small capital and inability to pay debts are alternative tests concerning the debtor's financial condition. This article focuses on the concept of "unreasonably small capital," which is not defined in the Bankruptcy Code or applicable state statutes. Consequently, the determination of adequate capital is fact-intensive and fertile grounds for litigation. This article is divided into two parts: first, a summary of the general standards used by courts for determining adequate capital, and second, a summary of two recent circuit court decisions addressing adequate capital: *Adelphia Recovery Trust v. FPL Group, Inc. (In re Adelphia),* 652 Fed. Appx. 19 (2d Cir. 2016) and *Whyte v. SemGroup Litigation Trust (In re SemCrude LP),* 648 Fed. Appx. 205 (3d Cir. 2016)).

What is Unreasonably Small Capital?

The leading case on adequate capital is the Third Circuit's decision in *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992), which defines the concept of unreasonably small capital as the "financial condition short of equitable insolvency" marked by the inability to generate sufficient profits to sustain operations. Stated differently, the question is whether the transfer left the "transferor technically solvent but doomed to fail." *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs., Co.*, 910 F. Supp. 913, 844 (S.D.N.Y. 1995); *see also Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 288, 302 (Bankr. D. Mass. 1997) ("[A] transaction leaves a company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency."). An "inadequately capitalized company may be able to stagger along for quite some time, concealing its parlous state or persuading creditors to avoid forcing it into a bankruptcy proceeding … " *Boyer v. Crown Stock Distribution, Inc.* 587 F.3d 787, 795 (7th Cir. 2009).

The test for adequate capital is predicated on "reasonable foreseeability." *Moody,* 971 F.2d at 1073 (3d Cir. 1992). The inquiry is intended to determine whether it was "reasonably foreseeable" that the company would not be able to sustain operations, given its capitalization level before or after the transfer. *Id.* To determine whether a company has adequate capital, courts expect the parties to present expert testimony focusing on the "long-term ability of an enterprise to sustain its liabilities." *In re Tronox*

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[2] State law constructive fraudulent statutes include substantively identical provisions.

Inc. v. Kerr McGee Corp. (In re Tronox Inc.), 503 B.R. 239, 322 (Bankr. S.D.N.Y. 2013). The analysis requires a comparison of the company's projected cash inflows with its capital needs throughout a reasonable period of time after the questioned transfer. *See In re Iridium Operating LLC*, 373 B.R. 283, 345 (Bankr. S.D.N.Y. 2007). Generally, the capital adequacy test is "passed" if the debtor is reasonably expected to have the financial wherewithal to pay its reasonably anticipated operating expenses, capital expenditures, debt repayment obligations and other liabilities in connection with the operation of the business. The plaintiff has the burden of proof.

The starting place for determining adequacy of capital is the financial projections prepared at the time of the transaction. *See Moody v. Security Pacific Business Credit, Inc*., 971 F.2d 1056 (3d Cir. 1992); *In re Plassein Int'l Corp.*, 2008 WL 1990315 (Bankr. D. Del. May 5, 2008). Because "projections tend to be optimistic, their reasonableness must be tested by an objective standard anchored in the company's actual performance." *Moody*, 971 F.2d at 1073. "To a degree, parties must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns and otherwise incorporate some margin for error." *Id*. Additionally, projections should be consistent with historical performance. *Id*. at 1074; *In re Tronox Inc.,* 503 B.R. at 321.

Courts look to expert opinions to confirm the reasonableness of the assumptions underlying the company's business plan. *Iridium*, 373 B.R. at 348. Without a "firm basis to replace management's cost projections with those developed in preparation of litigation," management's projections should be the starting point of any solvency analysis. *Id*. at 347. When there is substantial evidence presented to show that the business plan was prepared in a reasonable manner, using supportable assumptions and logically consistent computations, then the plan will constitute a fair, reasonable projection of future operations and alternative projections of future operations should be rejected. *In re Mirant Corp.*, 334 B.R. 800, 825 (Bankr. N.D. Tex. 2005). Courts examining the question of adequate capital also place great weight on the debtor's ability to obtain financing. *See, e.g., Moody*, 971 F.2d at 1071-73; *In re Plassein Int'l Corp.*, 2008 WL 1990315 (Bankr. D. Del. May 5, 2008); *Peltz v. Hatten*, 279 B.R. 710, 746-48 (D. Del. 2002). Courts also will examine other factors, including the company's leverage ratios, its historical capital cushion and the need for working capital in the specific industry at issue and the length of time between the transaction and bankruptcy filing. *MFS/Sun Life Tr.–High Yield Series v. Van Dusen*, 910 F. Supp. at 944; *In re Fid. Bond & Mortg. Co*., 340 B.R. at 299 (citing *Daley v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002)).

Recent Circuit Court Decisions

Adelphia Recovery Trust v. FPL Group, Inc. (In re Adelphia), 652 Fed. Appx. 19 (2d Cir. 2016) ("*Adelphia*").

In *Adelphia*, a plan litigation trust challenged a stock repurchase as a constructive fraudulent transfer. Having found that Adelphia was solvent with an equity cushion of approximately $2.5 billion, the bankruptcy court then analyzed whether Adelphia was adequately capitalized during the course of a four-day bench trial. The plaintiff's expert opined that Adelphia had unreasonably small capital and "would have been unable to maintain operations over a three year period due to its negative cash flow and lack of access to new capital." Dist. Ct. Opin., 2015 WL 1208588, at *3 (S.D.N.Y. Mar. 17, 2015). Although it was undisputed that Adelphia "required substantial capital expenditures to stay afloat over three years" in excess of $500 million, the trust's expert opined that Adelphia could not access the capital markets or generate capital from asset sales because of a confluence of three factors. *Id*.

First, the plaintiff's expert opined that Adelphia's debt covenants limited its ability to raise capital by selling assets. *Id*. at *4. The defendants' expert disagreed, and explained that Adelphia in fact had flexibility under its existing covenants to sell certain assets. *Id*. The bankruptcy court agreed with the defendants' expert, concluding that Adelphia could have sold assets to provide sufficient capital if necessary. *Id*. Second, the plaintiff's expert opined that Adelphia's high leverage ratio put it in breach of debt covenants contained in its bond indentures thereby restricting Adelphia's ability to borrow under its existing facility and further limited its access to the capital markets. *Id*. The defendants' expert presented a different picture and showed that at the time of the challenged transaction, Adelphia's debt-to-EBITDA ratio was 8.7 percent, which was below the 8.75 percent cap imposed by its debt covenants. *Id*. The defendants also pointed to industry comparisons, noting that certain of Adelphia's peers were able to access capital markets despite operating with negative cash flow and worse leverage ratios. *Id*. The bankruptcy court sided with the defendant's expert that Adelphia's high leverage ratio would not have caused Adelphia to lose access to the capital markets. *Id*.

Finally, the plaintiffs argued that Adelphia's access to the capital markets would have been "closed or severely limited" once Adelphia disclosed that it had fraudulently overstated its earnings by more than $400 million. *Id*. at *5. In opposition, the defendant's expert presented data from a study of 19 companies and "argued that while it was 'theoretically possible' that Adelphia would have lost access to the capital markets if the fraud had been disclosed, the empirical evidence shows that, under similar circumstances, companies were typically able to raise capital after the disclosure of a fraud." *Id*. Ultimately, the bankruptcy court concluded that the plaintiff had failed to satisfy its burden to establish that Adelphia would have lost access to the capital markets if its fraud had been disclosed. Because the dispute was non-core, the bankruptcy court's findings and conclusions of law were submitted to the district court's *de novo* review under 28 U.S.C. § 157(c)(1). The district court, after considering those findings and conclusions, entered judgment against the plaintiff.

The Second Circuit decision on appeal, which is only three pages (as compared to the bankruptcy court decision which exceeded 48 pages), begins by setting forth the standard of review: factual findings are reviewed for clear error and legal conclusions are reviewed *de novo.* Cir. Ct. Opin., 652 Fed. Appx. 19, 20 (2d Cir. 2016). Here, the court noted that most of the arguments concerning adequacy of capital are "mostly or entirely fact based." *Id*. After summarily describing the plaintiff's contentions on adequate capital, the Second Circuit found that the lower courts' findings — that "Adelphia could have sold off enough of its assets or alternatively obtained sufficient credit to continue its business for the foreseeable future" — were "amply supported by the declarations and trial testimony of defendants' experts, which showed, *inter alia*, that similarly-situated companies in the cable industry were able to access capital markets despite having negative cash flows and/or having high leverage ratios and that numerous other companies obtained access to capital markets after disclosing a fraud." *Id*. at 22-23. The Second Circuit affirmed the lower courts and concluded that the "record demonstrates that the issue of adequate capitalization came down to a battle of experts. We cannot say that the district court clearly erred in accepting as more persuasive the evidence presented by defendants' experts." *Id*. The Second Circuit's decision was a "summary order" with no "precedential effect." *Id*. at 19.

Whyte v. SemGroup Litigation Trust (In re SemCrude LP), 648 Fed. Appx. 205 (3d Cir. 2016) ("*SemGroup*").

In *SemGroup*, a plan litigation trust sought to avoid and recover certain dividends as constructive

fraudulent transfers. The issue of adequate capital hinged upon the reasonableness of SemGroup's reliance on its continuing ability to draw upon its existing line of credit. *Id*. at 210. The plaintiff argued that the company's reliance on continued access to its line of credit was unreasonable because SemGroup was engaged in a trading strategy involving naked-options, which it knew was prohibited under the credit agreement. The parties disputed, and the evidence was unclear, whether the lenders were aware that SemGroup was engaged in this prohibited trading strategy. *Id*. at 210-11. There was "no material allegation of fraud or criminal conduct" by SemGroup. *Id*. at 208. The bankruptcy court granted the defendants' motion for summary judgment and found that the plaintiff's argument "rested upon conjecture biased by hindsight such that it was not reasonably foreseeable that SemGroup would lose access to credit when it made the challenge equity distribution." *Id*. The district court affirmed. The trust appealed to the Third Circuit arguing that "there are at least questions of material fact to the issue of whether it was reasonably foreseeable that the Bank Group would have pulled their line of credit as a result of SemGroup's derivatives trading." *Id*. The Third Circuit reviewed the grant of summary judgment under a *de novo* standard. *Id*. at 208.

The Third Circuit affirmed and held that "it simply cannot be said that SemGroup was likely to be denied access to a credit facility that had been in place while it was engaging in the allegedly improper trading strategy." *Id*. at 211. The court refused to accept the trust's argument because doing so would have required the court to "forecast (1) the lenders' reaction to discovering the conduct, and then (2) the consequences of that reaction, *i.e.*, that the only option chosen by all of the lenders would have been to foreclose access to all credit, which (3) had the reasonably foreseeable consequence of bankruptcy." *Id*. (citing the district court). The court also noted that the trust "presented no evidence that SemGroup tried to disguise its trading strategy from the [lenders] or acted deceptively." *Id*. at 212. Thus, the court held, it was proper to find as a matter of summary judgment that SemGroup could not "reasonably foresee" that the lenders would declare a default upon learning of their trading strategy, nor could they foresee that their trading strategy would fail in the first place. *Id*.[3] The Third Circuit stated that the decision was "not an opinion of the full Court" and "does not constitute binding precedent." *Id*. at 207.

Conclusion

Proving inadequate capital is a fact-intensive exercise and litigated success will often hinge on the relative credibility and persuasiveness of each party's expert witnesses. Moreover, as *Adelphia* proves, it is difficult to reverse the trial court's finding of facts under the "clear error" standard of appellate review. Finally, as *SemGroup* confirms, the "reasonably foreseeable" standard requires proof beyond conjecture or speculation regarding the debtor's future access to capital. Absent such proof, summary judgment dismissal of the claim may be warranted.

[3] In a footnote, the court left open the question of whether there must be a causal connection between a challenged transaction and the adequacy of a debtor's capital. In addressing the defendants' argument that the equity distributions in the instant case "must be the cause of undercapitalization," the court decided that it "need not resolve the question of whether there must be a causal link between the challenged transaction and the status of the debtor's capitalization in this case because it cannot be shown that it was reasonably foreseeable at the time of the equity distributions that SemGroup would lack adequate access to capital." *Id*. at n. 6.

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Issues in the Application of the Section 546(e) Safe Harbor

I. Scope of Section 546(e)

A. Section 546(e) of the Bankruptcy Code creates a "safe harbor;" protecting certain types of transactions from avoidance; it prevents a bankruptcy trustee from avoiding a prepetition transfer:
   i. That is a settlement payment, made by or to (or for the benefit of) a stockbroker, financial institution, financial participant, or securities clearing agency, or
   ii. That is made in connection with a securities contract, and made by or to (or for the benefit of) a stockbroker, financial institution, financial participant, or securities clearing agency.

B. Section 546(e) does not apply to intentionally fraudulent transfers avoidable under § 548(a)(1)(A).

II. The question of whether section 546(e) preempts state law constructive fraudulent conveyance claims is not settled

A. In re Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016)
   i. Representatives of unsecured creditors sought, through state law constructive fraudulent conveyance actions, to recover payments made to shareholders pursuant to a leveraged buyout. The cashed-out shareholders argued that the state law constructive fraudulent conveyance actions were preempted by the section 546(e) safe harbor.[1]
   ii. The Second Circuit found that the meaning of section 546(e), with regard to the creditors' ability to bring state law constructive fraudulent conveyance actions, was ambiguous. Looking to the legislative history of section 546(e), the Court concluded that Congress intended to protect the securities markets from negative effects that might result from a large bankruptcy in the industry. The Court found that the larger purpose of section 546(e) was to provide finality and certainty to investors in the securities market; a goal accomplished by limiting the unwinding of securities transactions under the Bankruptcy Code to cases involving intentionally fraudulent transfers.
   iii. The Court further noted, that without such a limitation, investors would be exposed to increased risk, creating a "substantial deterrent" to investing in the securities markets.

B. In re Physiotherapy Holdings, Inc., No. 13-12965(KG), 2016 WL 3611831 (Bankr. D. Del. June 20, 2016)
   i. Litigation Trust sought to recover payments made to shareholders pursuant to a LBO. Payments were primarily made to two entities that respectively owned the two entities that had merged into the Debtor, and who also owned a combined majority of share of the Debtor.
   ii. The Bankruptcy Court rejected the Second Circuit's reasoning in Tribune and instead adopted the reasoning of a decision, abrogated by the holding of

[1] The creditors initially brought their claims in state court after obtaining stay relief. Their claims were later consolidated in a federal court action brought by the trustee of the Litigation Trust created pursuant to the Debtor's Chapter 11 plan.

Tribune, issued by the Bankruptcy Court for the Southern District of New York in the Lyondell case.

a. See In re Lyondell Chem. Co., 503 B.R. 348 (Bankr. S.D.N.Y. 2014), as corrected (Jan. 16, 2014) abrogated by In re Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016) ("Lyondell II").

iii. The Court started with the presumption that areas which fell under the historic police powers of a state, such as constructive fraudulent conveyance claims, were not preempted without a clear and manifest intent by Congress to do so. Looking to the legislative history, the Court then concluded that the purpose of section 546(e) was to prevent systemic risk in the securities industry, rather than providing finality for individual investors.

iv. The Court proceeded to analyze the state fraudulent conveyance claims to determine if they were an obstacle to the goal of section 546(e) of preventing systematic risk in the securities industry. The Court concluded that, as two entities owned over 90% of the Debtor's common stock, a ripple effect in the securities market caused by a creditors' victory in the action was unlikely. The Court therefore concluded that the systemic risk Congress sought to avoid in enacting section 546(e) was unlikely to occur, and, as such, the creditors' state law claims were not preempted.

III. Avoiding the application of the safe harbor by finding intentional fraud through the imputation of a corporate director's knowledge and fraudulent intent to a debtor corporation with a multi-member board – Lyondell III

A. In re Lyondell Chem. Co., 554 B.R. 635 (S.D.N.Y. 2016), reconsideration denied sub nom. In re: Lyondell Chem. Co., No. 16CV518 (DLC), 2016 WL 5818591 (S.D.N.Y. Oct. 5, 2016) ("Lyondell III").

B. Chairman and CEO of Lyondell, Mr. Dan Smith, presented long range projections to Debtor's Board showing inflated EBITDA. An investor later expressed interest in acquiring the Debtor, following which, Smith produced increased EBITDA figures that had been "refreshed." Using the refreshed figures a sole due diligence presentation was made to the interested investor. The trustee alleged that the Board knew or intentionally turned a blind eye to the fact that the refreshed figures contained grossly inflated earnings estimates. The Board subsequently approved the merger. The investor acquired the Debtor through a LBO 100% financed by the Debtor's assets. The Debtor filed for bankruptcy slightly over one year after the merger was completed.

C. The Trustee brought an action to recover the payments made to the shareholders under section 548(a)(1)(A) and state law fraudulent conveyance claims. The state law claims were dismissed after the Second Circuit's decision in the Tribune case was issued. Ruling on a motion to dismiss, the Bankruptcy Court held that the standard for imputing Smith's intent to the Board was whether or not he was in a position to control the disposition of Lyondell's property. As Smith was one member of a multi-member board the Bankruptcy Court concluded that Smith's intent could not be imputed to Lyondell, and, finding that the Trustee had failed to show that a critical

mass of the multi-member board had the actual intent required, held that the section 548 claims should be dismissed.

D. The District Court disagreed with the Bankruptcy Court, holding that Smith's fraudulent intent could be imputed to the Board under well-established agency principles and, as a result, the Trustee's claims under section 548 were sufficiently pled to survive a motion to dismiss.

E. To reach this result, the District Court looked to Delaware precedent imputing an employee's knowledge to an employer if: (1) the knowledge was gained in the scope of employment, (2) the knowledge pertains to the employee's duties, and (3) the employee had the authority to act upon the knowledge. Analyzing Smith's actions in preparing the EBITDA projections, presenting the same to the Board, and his negotiations in connection with the LBO, the District Court found that Smith's knowledge of, and his intent in creating, the inflated EBITDA projections could be imputed to Lyondell.

F. The District Court then examined Smith's intent through an analysis of the badges of fraud. The Bankruptcy Court had found three badges of fraud present in the transaction, which were: (1) that the transfer was made to an insider as the board members received substantial payments as a result of the LBO, (2) that the transfer was of substantially all of the debtor's assets as the LBO led to the encumbrance of a very large proportion of the Debtor's assets, and (3) that the debtor became insolvent shortly after the transfer was completed. The District Court accepted these findings, and concluded that the Trustee had adequately pled "facts from which it can properly be inferred that Smith not only recklessly disregarded the likelihood that the LBO would quite quickly injure creditors, but also contemplated and believed that Lyondell would default on its obligations to its creditors within a very short period of time." This combined with the prior finding that Smith's knowledge and intent could be imputed to Lyondell, led the District Court to reverse the Bankruptcy Court's dismissal of the intentional fraudulent conveyance claims.

G. Contra In re Tribune Co. Fraudulent Conveyance Litig., No. 11-MD-2296 (RJS), 2017 WL 82391 (S.D.N.Y. Jan. 6, 2017) (Citing the Bankruptcy Court's decision in Lyondell II.).

    i. The District Court, disagreeing with the Lyondell III Court, held that "an officer's wrongful intent may be imputed to the corporation 'by establishing that [the officer], by reason of the ability to control' members of the board, 'caused the critical mass' to form 'an actual intent to hinder, delay or defraud creditors.'"

    ii. The District Court further found "that [such a] test appropriately accounts for the distinct roles played by directors and officers under corporate law, while also factoring in the power certain officers and other actors may exercise over the corporation's decision to consummate a transaction."

Issues in the Application of the Section 546(e) Safe Harbor

IV. Payments made in connection with a leveraged buyout have been held to be settlement payments

A. Definition of Settlement Payment - Section 741(8):
   i. The Code defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

B. In re Kaiser Steel Corp., 952 F.2d 1230 (10th Cir. 1991)
   i. The Tenth Circuit interpreted the Bankruptcy Code's definition of settlement payment to include payments made in connection with a leveraged buyout. The Kaiser Steel Court first noted that the Code's definition of "settlement payment" is extremely broad. The Court then looked to the prevailing meaning of "settlement" in the securities industry and concluded that, given the broad and varied industry specific meaning of settlement and the wide range of transactions undertaken in the securities industry, it would not limit the definition of settlement payment by excluding extraordinary securities transactions such as LBOs.

C. Several other Circuits have also held that LBO payments qualify as settlement payments under the Code. See In re Resorts Int'l, Inc., 181 F.3d 505 (3d Cir. 1999); Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); In re QSI Holdings, Inc., 571 F.3d 545 (6th Cir. 2009); In re Tribune Co. Fraudulent Conveyance Litig., 818 F.3d 98 (2d Cir. 2016).

V. Circuits are split on whether a financial intermediary listed in section 546(e) is required to obtain a beneficial interest in the property transferred in order to invoke the safe harbor

A. Matter of Munford, Inc., 98 F.3d 604 (11th Cir. 1996)
   i. Chapter 11 trustee sought to recover payments made to shareholders pursuant to a LBO. The transfer was effected through a financial institution.
   ii. The Eleventh Circuit held that the LBO payments were made by the Debtor to the shareholders, none of whom were included in the list of defined entities in section 546(e). The Munford Court concluded, that as the financial intermediaries that were "presumptively involved" in the transaction never acquired a beneficial interest in the transferred funds, they were "nothing more than an intermediary or conduit," and, therefore, section 546(e) was inapplicable to the transfer.

B. FTI Consulting, Inc. v. Merit Mgmt. Grp., LP, 830 F.3d 690 (7th Cir. 2016)
   i. Trustee of litigation trust created under the Debtor's Chapter 11 plan sought to avoid transfers made in connection with the Debtor's purchase of a competitor's stock. A number of banks were used to complete the transfer.
   ii. The Seventh Circuit refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." The Court interpreted the "made by or to (or for the benefit of)" language of section 546(e) to mean transfers

made *by the Debtor to a financial intermediary that is a creditor*, finding that the safe harbor created by section 546(e) only applies if the Debtor incurred an actual obligation to one of the listed entities.

C. In re Resorts Int'l, Inc., 181 F.3d 505 (3d Cir. 1999)
   i. Debtor sued to recover amount paid to a former shareholder through a LBO, where the shareholder had received the merger price after demanding an appraisal.[2] The shares were transferred from the shareholder to his broker, who then transferred them to the Debtor's Transfer Agent for the merger. Payment for the shares was then transferred to the shareholder along the same chain, but in reverse.
   ii. Debtor claimed that none of the financial intermediaries involved had a beneficial interest in the property transferred and therefore section 546(e) did not apply as the transfer was not "made by or to (or for the benefit of)" one of the defined entities listed in section 546(e). The Debtor argued that the transfer was instead a transfer by the Debtor to a shareholder, with the financial intermediaries serving as mere conduits.
   iii. The Third Circuit disagreed with the Munford Court and held that no beneficial interest in the transferred property was needed to invoke section 546(e).

D. Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009)
   i. Debtor sued former shareholders of a privately held corporation seeking to recover payments made through a LBO. The transaction was performed through a financial institution acting as an escrow agent. The Debtor argued that the financial institution was required to have a beneficial interest in the property transferred to invoke the section 546(e) safe harbor.
   ii. The Eighth Circuit agreed with the Third Circuit, holding that a plain reading of section 546(e) did not require the financial institution to have a beneficial interest in the property transferred. The Court held that the settlement payments involved were both *made to and then by a financial institution* and therefore qualified for protection of section 546(e).

E. In re QSI Holdings, Inc., 571 F.3d 545 (6th Cir. 2009)
   i. Adopting the view of the Third and Eighth Circuits that it is not necessary for one of defined financial intermediaries listed in section 546(e) to acquire a beneficial interest in the property transferred in order to trigger the safe harbor.

F. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011)
   i. Debtor sought to recover payments made to redeem commercial paper. Redemption occurred through the Depository Trust Corporation, a securities clearing agency.

[2] Prior to surrendering his shares the shareholder had demanded the right to seek an appraisal and had filed two actions against the Debtor in federal court. Four days after filing the second action the shareholder tendered his shares and was paid the merger price. When the Debtor discovered this it filed suit in state court asserting various state law fraud causes of action. The action was later removed.

ii. Citing Resorts International and Contemporary Industries, the Court refused to accept the Debtor's argument that section 546(e) required the financial intermediary involved to have a beneficial interest in the property transferred in order to invoke section 546(e).

iii. This holding was reinforced in In re Quebecor World (USA) Inc., 719 F.3d 94 (2d Cir. 2013) ("To the extent Enron left any ambiguity in this regard, we expressly follow the Third, Sixth, and Eighth Circuits in holding that a transfer may qualify for the section 546(e) safe harbor even if the financial intermediary is merely a conduit.").

VI. Section 546(e) has been found to apply to transfers made in connection with a Ponzi scheme, even if no securities were actually traded by the entity operating the Ponzi scheme

A. In re Bernard L. Madoff Inv. Sec. LLC, 773 F.3d 411 (2d Cir. 2014)

i. The Second Circuit concluded that payments made to investors in a Ponzi scheme, even in instances where the investors received more than they invested in the scheme, were both payments in connection with a securities contract and settlement payments, and further held that they were protected by the section 546(e) safe harbor.

ii. The Court looked at the broad definition of securities contract in section 741(7) of the Code, which includes an expansive list of agreements, as well as, "any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph." Section 741(7)(vii).

iii. The Court then analyzed the account agreements the Madoff investors were required to execute in order to invest in the Ponzi scheme. Concluding that the documents constituted a securities contract, the Court found that the payments would not have occurred but for the account agreements, and were therefore payments in connection with a securities contract.

iv. The Court also found that the payments were settlement payments, reasoning that each withdrawal request by an investor involved the contemplation, on the part of that investor, that securities would actually be transferred and payments received in settlement of the transaction.

VII. Section 546(e) has been found to apply to the redemption of commercial paper

A. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011)

i. The Second Circuit rejected the argument that a transaction qualifying as a settlement payment requires a purchase or sale, holding that payments for the redemption of commercial paper were settlement payments qualifying for the section 546(e) safe harbor.

ii. Judge Koeltl (sitting by designation) dissented, arguing that defining settlement payment to include transactions not involving a purchase or sale is contrary to the legislative history and threatens routine avoidance proceedings in bankruptcy court.

VIII. Courts have found that publicly traded securities do not need to be involved in in order to invoke the safe harbor

A. Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009)
   i. The Eighth Circuit rejected an argument that, as the transfers at issue involved privately held securities of a closely held corporation, the reversal of the transfers presented no risk to the nation's financial markets. It was argued that, because the prevention of such risks was the primary concern of Congress in enacting section 546(e), privately held securities were excluded from the safe harbor.
   ii. The Court concluded that nothing in the language of section 546(e) and 741(8) excluded privately held securities from either the definition of settlement payment or the safe harbor.

B. The Third and Sixth Circuits have reached the same result. See also In re QSI Holdings, Inc., 571 F.3d 545 (6th Cir. 2009), see also In re Plassein Int'l Corp., 590 F.3d 252 (3d Cir. 2009).

C. The Second Circuit has not directly addressed the issue, however, in In re Quebecor World (USA) Inc. the Court invoked the safe harbor to protect transfers used to prepay private placement notes, which the Court characterized as transfers made in connection with a securities contract. 719 F.3d 94 (2d Cir. 2013).

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Trends in Bankruptcy Litigation

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Managing Director

ABI Conference
New York, NY
May 18, 2017

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Roadmap

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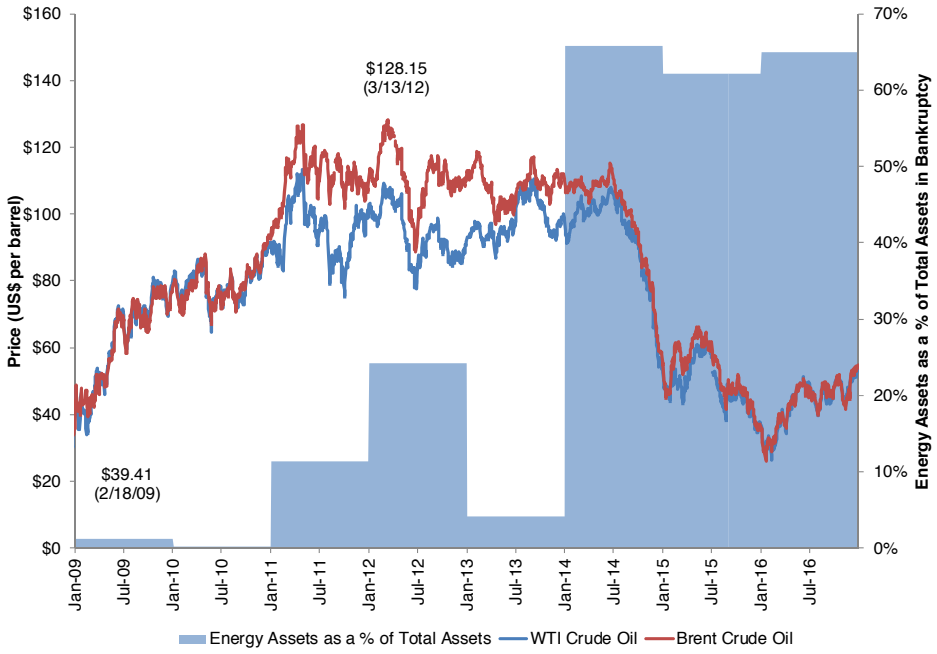
- Can market evidence be used to evaluate the reasonableness of management projections?
- How can capital adequacy be tested?

1

Can Market Evidence be Used to Evaluate Management Projections?

Crude Oil Prices and Energy Bankruptcies

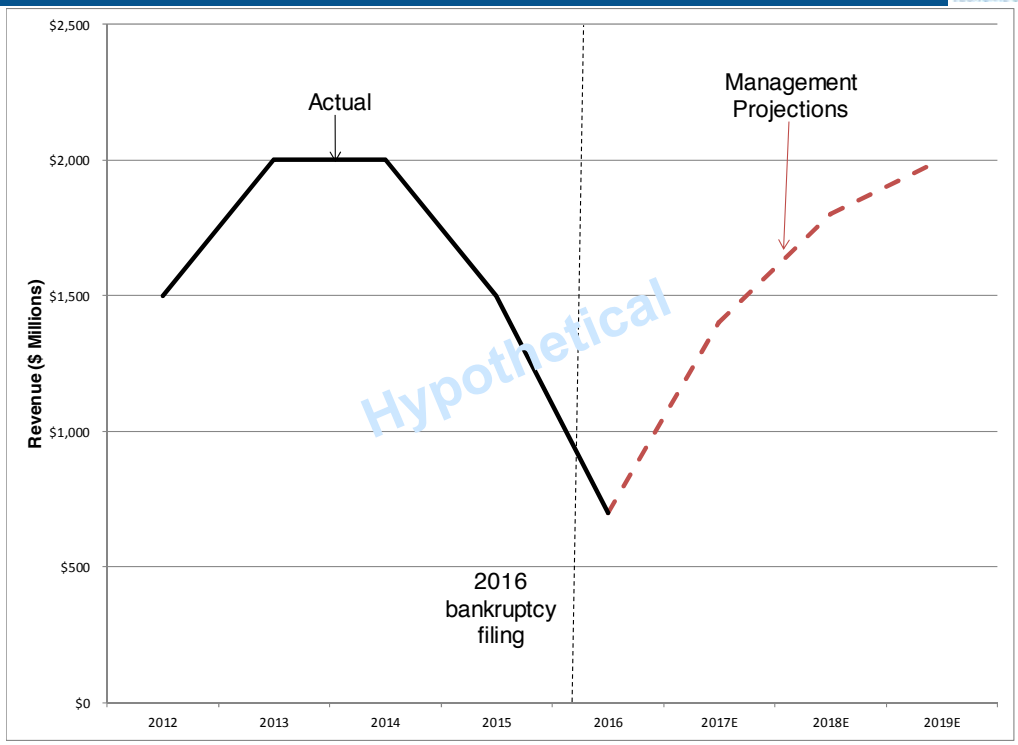


Management Projections as Basis for Feasibility Plan

- Oil rig company sought plan confirmation in 2016
- Senior creditors challenged the plan as too optimistic
- Management projections depend upon assumptions regarding:
  - Rig utilization rates
  - Day rigrates

4

Actual and Management Revenue Projections



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Assumptions Underlying Management Projections

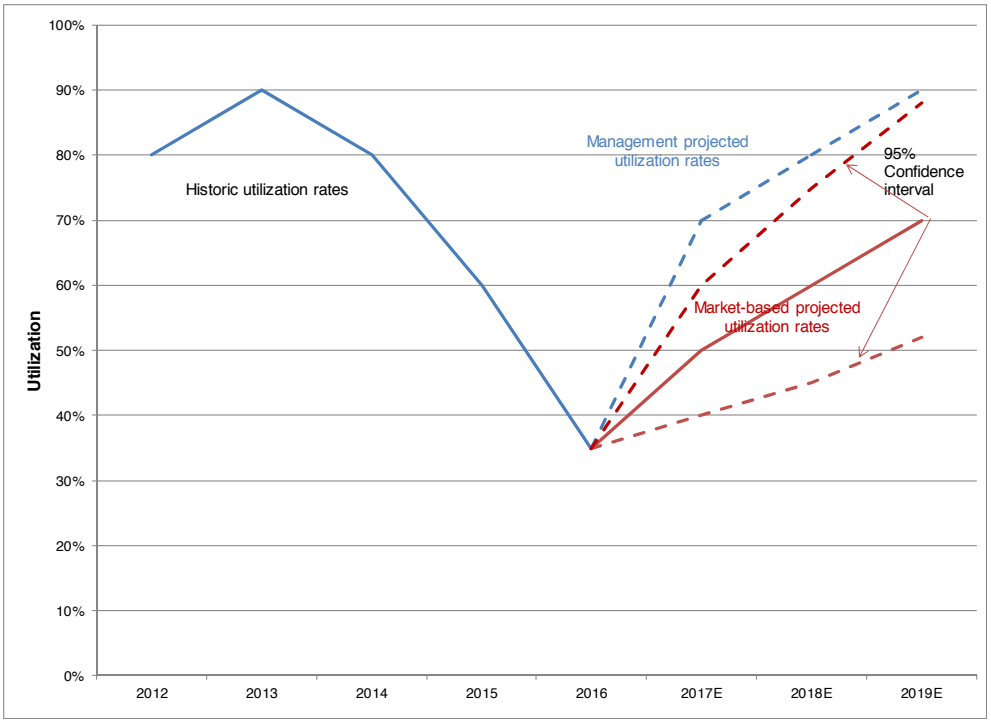
Crude Oil Prices
- Futures prices
- Industry forecasts

Utilization
- Industry forecasts
- Analytical models

Rig dayrates
- Industry forecasts
- Analytical models

6

Are Management Projections Consistent with Industry Expectations?



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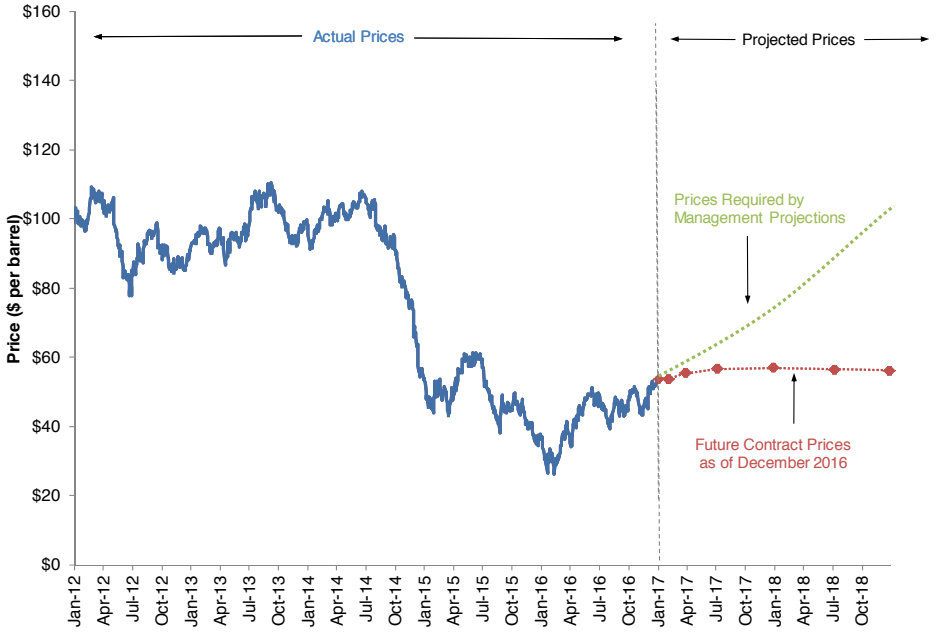
How High Do Expected Oil Prices Need to Be for Projections to Hold?



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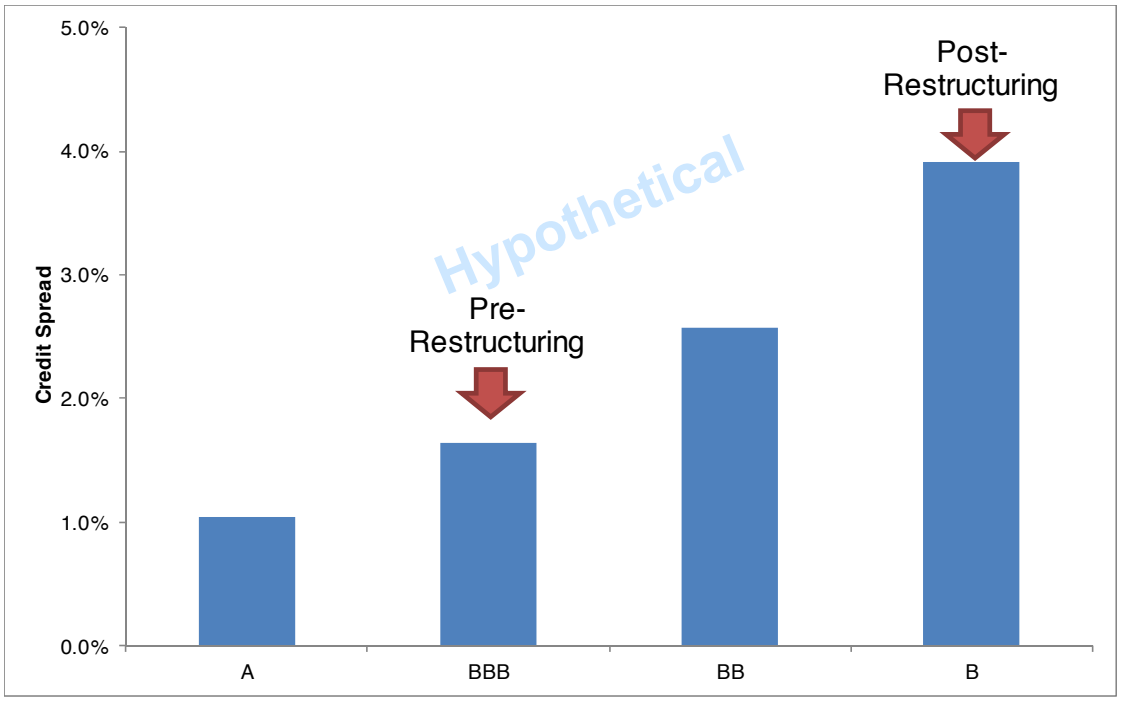
Credit Spreads Pre and Post Restructuring



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Can Capital Adequacy Be Tested?

10

What is Adequate Capitalization?

- "Viewed in this light, an "unreasonably small capital" would refer to the inability to generate enough cash flow to sustain operations." *Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992)*
- "The test is aimed at transferees that leave the transferor technically solvent but doomed to fail." *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs.Co., 910 F. Supp. 913, 933 (S.D.N.Y. 1995*)
- [T]he difference between insolvency and "unreasonably small" assets in the LBO context is the difference between being bankrupt on the day the LBO is consummated and having such meager assets that bankruptcy is a consequence both likely and foreseeable." *Boyer v. Crown Stock Distribution Inc., 587 F.3d 787, 794 (7th Cir. 2009).*

11

A Subjective Standard?

"Mirror, mirror, on the wall ... 'It's all so subjective' is not an acceptable answer."

12

No Hindsight

"Here, [the Trustee] would have the court, in effect, forecast

- (1) the lenders' reaction to discovering the conduct, and then
- (2) the consequences of that reaction, i.e., that the only option chosen by all of the lenders would have been to foreclose access to all credit, which
- (3) had the reasonably foreseeable consequence of bankruptcy."

I agree with the bankruptcy court that what appellant proposes is a "speculative exercise" not rooted in the case law."

In re SemCrude, L.P., 2016 BL 135006 (3d Cir. Apr. 29, 2016).

13

Access to Capital Markets

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- Which factors preclude capital market access?
  - 10 –to- 1 leverage ratio
  - Accounting fraud
  - Breach of covenants

14

Leverage Ratios

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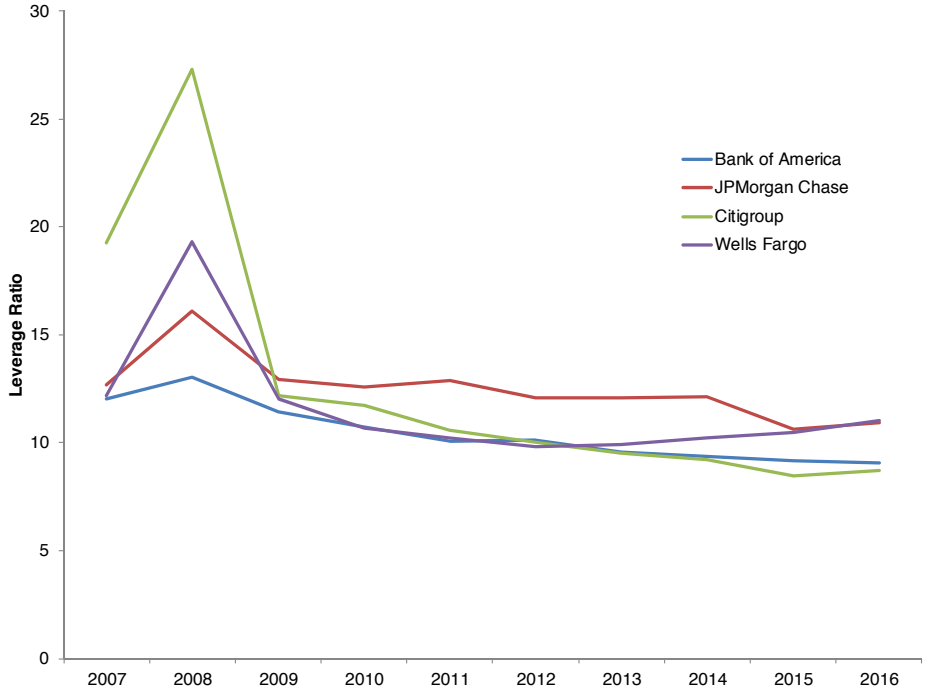

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