Northeast Bankruptcy Conference and Consumer Forum

Commercial Issues Roundup

Brian Davies
Capstone Partners | Boston

D. Ethan Jeffery
Murphy & King | Boston

John J. Monaghan
Holland & Knight LLP | Boston

Cristine Pirro Schwarzman
Ropes & Gray LLP | Brooklyn, N.Y.

Hon. David S. Jones
U.S. Bankruptcy Court (S.D.N.Y.) | New York

CONCURRENT SESSION

2022

ABI Northeast Conference 2022

Hot Topics in Bankruptcy

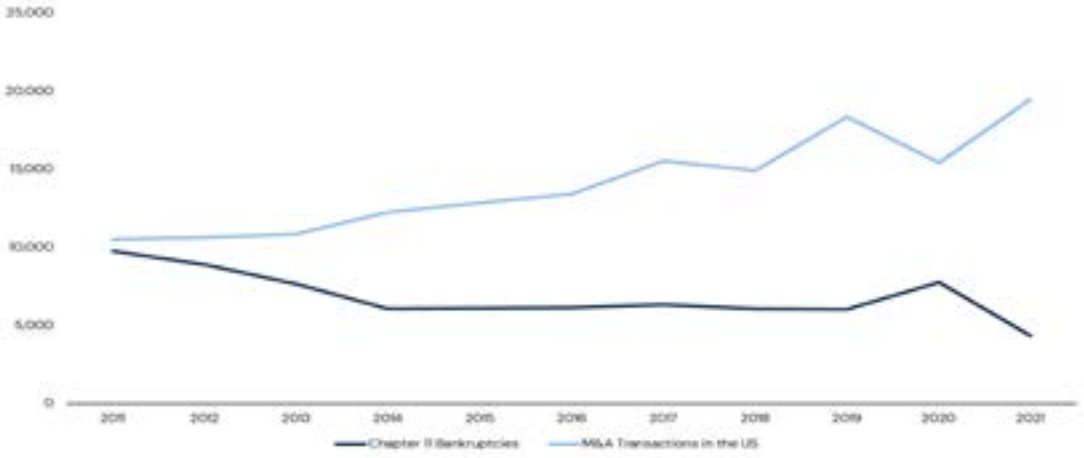
July 16, 2022

This Presentation:

1. Describes recent bankruptcies and M&A activity;
2. Provides a modern overview of the Texas Two-Step;
3. Explains modern trends in implementing effective make-whole provisions;
4. Describes considerations regarding equitable mootness; and
5. Provides an update with respect to recent developments in U.S. Trustee fees

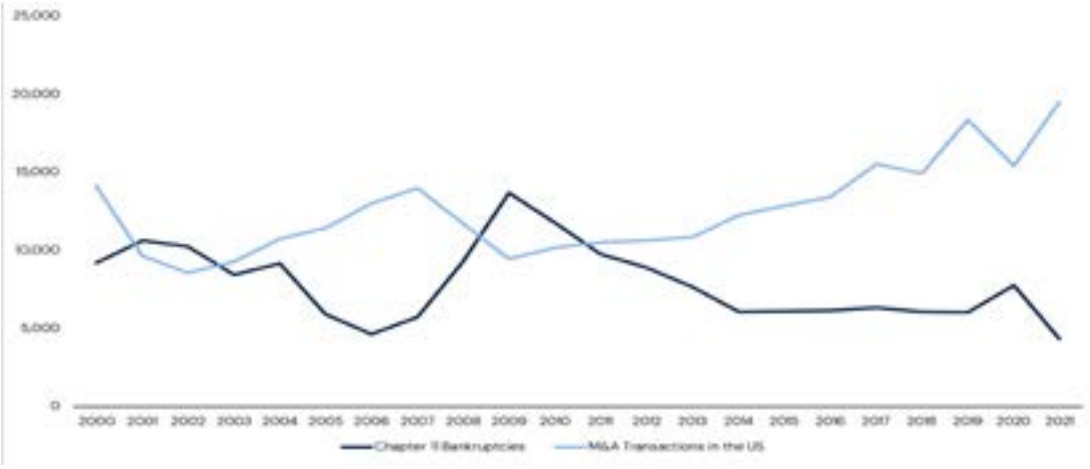
BANKRUPTCIES AND M&A ACTIVITY

Chapter 11 Bankruptcies (businesses only) and U.S. M&A Activity from 2011 - 2021



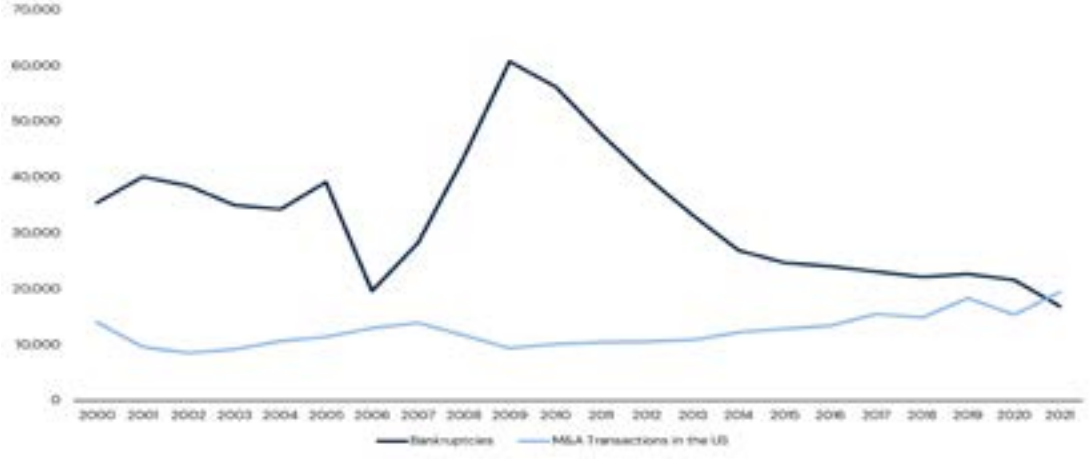
Sources:
American Bankruptcy Institute
Institute for Mergers, Acquisitions and Alliances
Capital IQ

Chapter 11 Bankruptcies (businesses only) and U.S. M&A Activity from 2011 - 2021



Sources:
American Bankruptcy Institute
Institute for Mergers, Acquisitions and Alliances
Capital IQ

Chapter 11 Bankruptcies (businesses only) and U.S. M&A Activity from 2011 - 2021



Sources:
American Bankruptcy Institute
Institute for Mergers, Acquisitions and Alliances
Capital IQ

U.S. Business Bankruptcies by Bankruptcy Type and U.S. M&A Activity from 2011 – 2021

Sources:
American Bankruptcy Institute
Institute for Mergers, Acquisitions and Alliances
Capital IQ

Why Are We Going to Ignore History

Most market cycles follow a pattern.

- First, liquidity is reduced in the system and hidden leverage emerges. We just saw this happen in crypto.
- Second, investors seek the "risk off" trade, which often exposes the lack of depth in non-core asset classes. IPOs decline, look at SPACs drying up, emerging market securities seem less attractive, and high yield tails off.
  - In high yield, as an example:
    - YTD new issuance is down 75%. No appetite for risk.
    - CCC rated bonds now yield an average of 12% versus ~6% as recently as May. No liquidity in secondary market causes prices to adjust.
- Third, valuations experience increased dispersion.
  - In robust markets, cheaper assets are bid up, reducing dispersion of multiples, yields, whatever.
  - In fearful markets, people see riskier assets, often in illiquid conditions, and valuations plunge. At the same time, there is a flight to quality with new cash, so high-quality assets do very well.

Why Are We Going to Ignore History

These trading market patterns also find their way into the M&A market.

- First, volume declines
  - Supply: PE sellers are more market timers and may hold back on some sales, but most sellers in lower middle market are driven by non-market factors. Overall, a small decline in supply
    - In fact, higher interest rates often bring sellers as the business owner can reinvest proceeds at a positive yield to replace income
  - Demand: With operating challenges (supply chain, pricing/inflation, fuel costs, etc.), strategic buyers turn to internal factors and the M&A aperture tightens significantly. Deals need to be a tighter match and/or fill a current strategic need. PE will continue to be bigger buyers, but again are more sector specific and there is a flight to quality ahead of potential volatility/weakness. Expect more deals to be pulled or delayed.
  - Overall volume declines result
- Second, wider ranges of valuations begin to appear
  - Fit with buyer can drive urgency and pricing up on quality assets
  - Deals with less strategic fit and more of a financial valuation will price down due to higher discount rate (more uncertainty, higher interest rates, likely higher
    mix of equity versus debt capital)
  - Expect to see more structure in deals as a risk transfer from buyer to seller

Why Are We Going to Ignore History

Will M&A fall off like the ’08-09 cycle?

- Not likely. Economic cycles are normal, harsh credit cycles less so. The main driver of the Great Recession:
  - The collapse of the subprime mortgage markets
    - Defaults on high-risk housing loans led to a credit crisis in the global banking system and a steep drop in bank lending.
- More lending now done with private lenders versus regulated banks
- All of the operational factors in play should increase strategic M&A – seek buy versus build answers to pressing issues
- “Zombie companies” (no growth companies that continue on due to capital availability) will begin to seek longer term solutions
- Lower middle market deals are driven more by demographics than by market conditions
- PE asset class remains well funded and flush with cash – need to spend it
- We see “distressed M&A” volumes increasing – companies under pressure to sell.

TEXAS TWO-STEP

What is the "Texas Two-Step"?

- A statutory mechanism to reorganize a corporate family under Texas Law.
- The key sections of the Texas Business and Organizations Code (the "TBOC") have been the law since at least 2003 (and in fact substantially similar language was present in the TBOC's predecessor statute).
- Employs a "divisive merger" to split one or more companies into multiple companies.
- Allows for the allocation of assets and liabilities among entities party to the divisive merger in accordance with a plan of merger.
- Newly created entities are not liable for obligations of pre-merger entities unless those liabilities were allocated to the new entity in accordance with the plan of merger.
- The allocation of assets and liabilities is deemed to occur with no transfer or assignment having taken place.

Step 1: Conversion to a Texas Entity

- The TBOC provides that a foreign entity may convert to a Texas entity if:
  - it adopts a plan of conversion as provided by the TBOC;
  - in converting to a Texas entity, it complies with the laws of the jurisdiction of formation and its governing documents; and
  - the conversion is permitted by the laws of the jurisdiction where the entity is incorporated or organized and by its governing documents.
- No notice or opportunity to object to the conversion of an entity to a Texas-entity is required by Texas Law.
- However, under Delaware law, for example, the board of directors of an entity converting to a Texas-entity must adopt a resolution to that effect and provide 20-days' notice to its shareholders who must vote to approve the resolution at an annual or special meeting.

Step 2: Split into two or more entities

- "Merger" includes a combination of two or more entities, as well as:
  - "." the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations

Original Entity Must Adopt a Plan of Merger

- Plan of Merger must contain, among other things:
  - Details concerning each organization that is a party to the merger or would be created by the merger;
  - Manner and basis of converting or exchanging ownership or membership interests of each entity that is a party to the merger into ownership or membership interests in new entities, cash, or other property;
  - Identification of any ownership interests that will be cancelled, exchanged, or that will remain outstanding;
  - The new formation and governing documents of each entity created by the merger; and
  - The manner and basis of allocating assets and liabilities among each entity that survives the merger.
- Importantly, Texas law provides that assets and liabilities of the predecessor-entity are allocated in accordance with the plan of merger **without a transfer or assignment having taken place.**

Impact of Divisional Merger Under Texas Law

- Assets and liabilities may be allocated to surviving entities at the discretion of management. As a result, a newly created entity may be shielded from the liabilities of the predecessor-entity, even though it receives assets from that entity. Again, no transfer or assignment is deemed to occur.
- However, an entity that succeeded to the liability in question can be substituted into pending litigation.

Texas Corporation's Law's Tepid Attempt at a Savings Clause

- The merger statute contains a savings clause which provides: "[t]his code does not affect, nullify, or repeal the antitrust laws or abridge any right or rights of any creditor under existing laws."
    - No published opinion addresses how this section interacts with the previously discussed portions of the TBOC.
    - Curtis Huff, a primary drafter of the relevant portions of the TBOC, has said "all laws protecting the rights of creditors with respect to fraudulent conveyances, preferences and insolvency will remain in force and apply . . . Principal among the laws available to protect creditors in mergers with multiple survivors are the Uniform Fraudulent Transfer Act, the Uniform Fraudulent Conveyance Act and the United States Bankruptcy Code of 1978, as amended."

Original Entity Must Adopt a Plan of Merger

- Plan of Merger must contain, among other things:
    - Details concerning each organization that is a party to the merger or would be created by the merger;
    - Manner and basis of converting or exchanging ownership or membership interests of each entity that is a party to the merger into ownership or membership interests in new entities, cash, or other property;
    - Indentification of any ownership interests that will be cancelled, exchanged, or that will remain outstanding;
    - The new formation and governing documents of each entity created by the merger; and
    - The manner and basis of allocating assets and liabilities among each entity that survives the merger.
- Importantly, Texas law provides that assets and liabilities of the predecessor-entity are allocated in accordance with the plan of merger **without a transfer or assignment having taken place.**

The Two-Step in Action

Johnson & Johnson's Corporate Reorganization

Relevant Pre-Texas Two Step Corporate Structure

Janssen Pharmaceuticals, Inc.

Johnson & Johnson Consumer Inc. ("Old JJCI")

- Holds all liabilities related to J&J Baby-Powder and other talc products.

Johnson & Johnson's Corporate Reorganization

J&J Consumer Inc. Creates Royalty A&M

Janssen Pharmaceuticals, Inc.

Johnson & Johnson Consumer Inc. ("Old JJCI")
- Holds all liabilities related to J&J Baby-Powder and other talc products.

Royalty A&M
- Funded with $367 Million in exchange for Royalty's equity
- $367 Million immediately used to acquire royalty streams from Old JJCI

Johnson & Johnson's Corporate Reorganization

Janssen Pharmaceuticals creates Currahee Holding Company Inc., and contributes Old JJCI's equity

Janssen Pharmaceuticals, Inc.

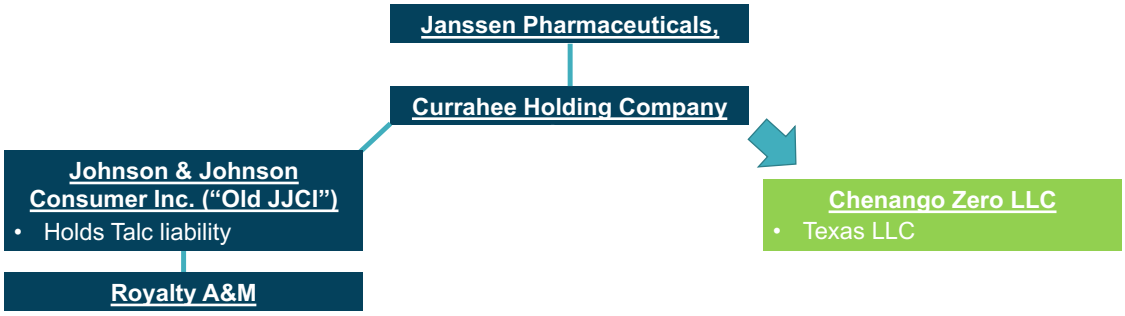
Currahee Holding Company Inc.
- Given 100% of Old JJCI's equity

Johnson & Johnson Consumer Inc. ("Old JJCI")
- Holds Talc liability

Royalty A&M

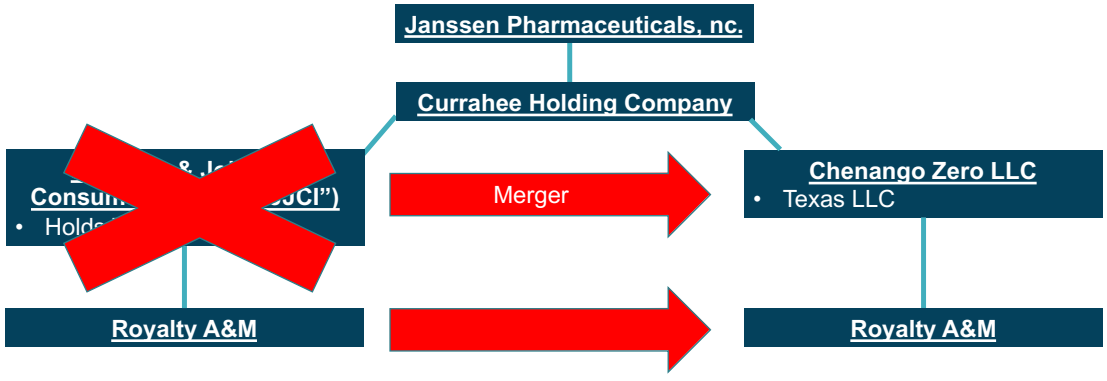
Johnson & Johnson's Corporate Reorganization

Currahee Holding Company Inc. creates Chenango Zero LLC



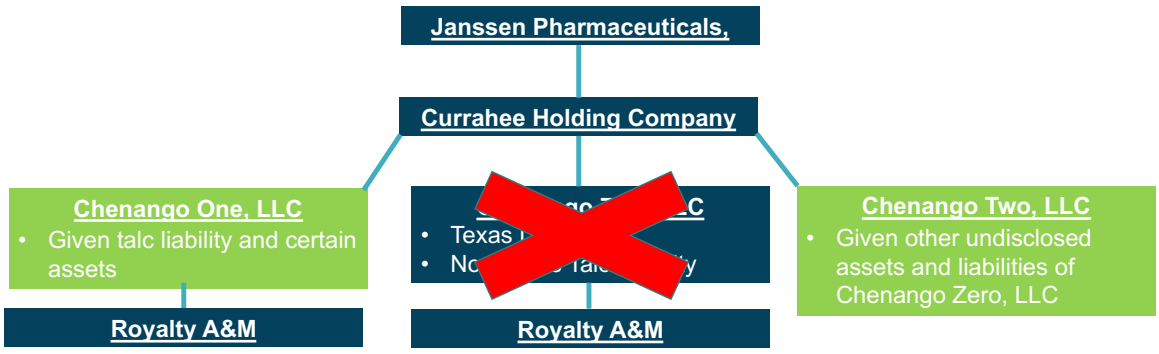
Johnson & Johnson's Corporate Reorganization

Old JJCI merges with and into Chenango Zero LLC, and Royalty A&M becomes subsidiary of Chenango Zero



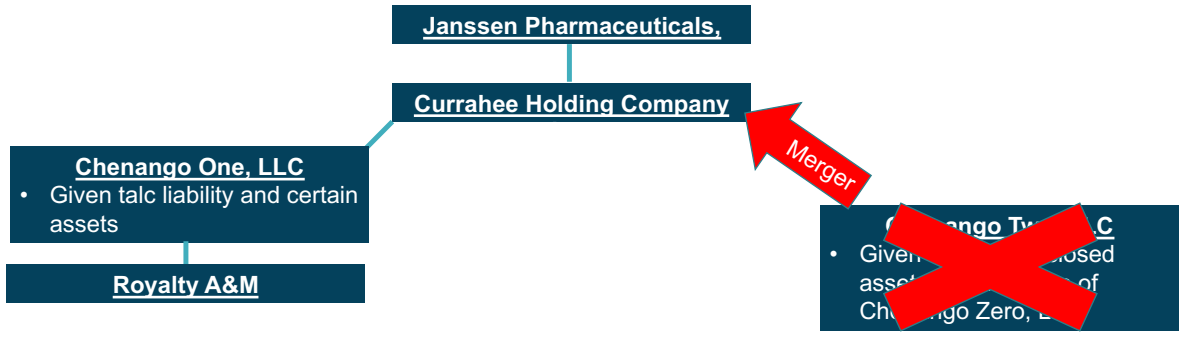
Johnson & Johnson's Corporate Reorganization

Chenango Zero LLC effects a Divisional Merger, creating Chenango One, LLC and Chenango Two, LLC



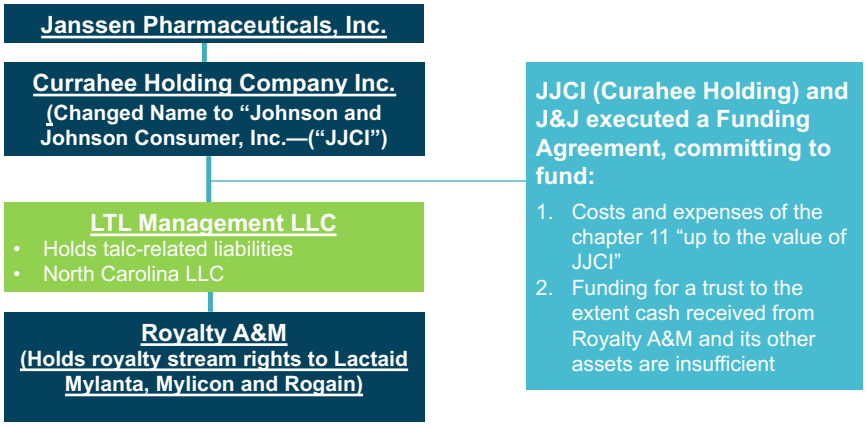
Johnson & Johnson's Corporate Reorganization

Chenango Two, LLC merges with and into Currahee Holding Company, Inc.



Johnson & Johnson's Corporate Reorganization

Chenango One converts to a North Carolina LLC and changes name to LTL Management LLC.



LTL Management Bankruptcy Case—The WDSC And Venue

- Johnson & Johnson controlled entities underwent the Texas Two-Step in early October, 2021.
- On October 14, 2021, LTL Management LLC ("LTL") filed for bankruptcy in the Western District of North Carolina. LTL's stated value is $373 million, compared to a market cap of $435 billion for the J&J conglomerate.
- Shortly thereafter, LTL filed a motion to enforce the automatic stay against its non-debtor affiliates.
  - This motion was granted in part, with the court issuing a TRO preventing the continuation of litigation against a single LTL-affiliate.
  - The court expressed concern that Johnson & Johnson may have independent liability for the talc claims, and that LTL was unable to produce documentation evidencing that LTL was solely responsible for the talc liability.
- On October 25, 2021, a motion to transfer venue from North Carolina to New Jersey was filed on the basis that, among other things, LTL's employees and assets are in New Jersey, the majority of its talc litigation is in New Jersey, and relevant witnesses are in New Jersey and not North Carolina. On October 26, 2021, the Court entered an order to appear on November 10, 2021 and show cause why the case should not be transferred to New Jersey.
- On November 11, 2021, the North Carolina Bankruptcy Court transferred LTL's case to the District of New Jersey despite LTL's argument that it should stay in North Carolina due to the district's experience with Texas Two-Step cases. While doing so, the North Carolina court also issued a 60-day preliminary injunction prohibiting the continuation of talc-litigation because "the last thing [the Court] want[s] to do is send [the case] on fire."

LTL Management Bankruptcy Case—Issue 1—Is It A Bad Faith Filing?

- In a 54 Page Decision, Chief Bankruptcy Judge Kaplan Of The District of New Jersey Denied A Motion To Dismiss The LTL Chapter 11 Case as a Bad Faith Filing "In Their Entirety"
  - "Movants and other talc claimants, in their own words, view their tasks as moral and legal imperative to vigorously oppose both J&J and Old JJCI to utilize the bankruptcy system as a litigation tactic to address their talc-related litigation liabilities through this Debtor."
  - "With respect to the use of the now infamous 'Texas Two-Step," the Court finds nothing inherently unlawful or improper with application of the Texas divisional merger scheme in a manner which would facilitate a chapter 11 filing for one of the resulting new entities …. Certainly I can say with some confidence, that the legislature which passed the statute into law probably did not foresee its current popular use. Notwithstanding, the statute makes clear the legislative intent that there be a neutral impact on creditors. … I am not prepared to rule that use of the statute as undertaken in this case, standing alone, evidences bad faith."
  - "Argument has been put forward by Movants, other parties in interest, and the drafters of the amici curie brief that allowing this case to proceed will inevitably 'open the floodgates' to similar machinations and chapter 11 filings by other companies defending mass tort claims. Given the Court's view that the establishment of a settlement trust within the bankruptcy system offers a preferred approach to best serve the interests of injured tort claimants and their families, maybe the gates indeed should be opened."
- Chief Judge Kaplan certified his decision and opinion to the Court of Appeals for the Third Circuit for Direct Appellate review
  - The Appellants' brief were submitted on June 30, 2022.

LTL Management Chapter 11 Case—Issue 2 — Can The Stay Be Extended To Non-Debtors?

- The Debtor brought an adversary proceeding seeking various forms of relief precluding the tort plaintiffs from continuing or proceeding with litigation against various non-debtors, including affiliates of the Debtor and retailers who sold the talc products.
  - "In this Court's view, ample authority exists to conclude that § 362(a), § 105, or a court's inherent powers can each serve as independent bases for extension of a stay to nondebtor third parties."
  - "[T]his Court finds no impropriety in the divisional merger used here to create a special-purpose vehicle to address the talc claims and, thus, perceives no 'absurd or unjust' result produced if the automatic stay is extended to the Protected Parties to achieve its ultimate objective. As Debtor points out … if the stay is not extended to the Protected Parties, it is difficult to envision how a successful reorganization can be achieved in this case."
  - "Here, the Court finds that the nondebtor Protected Parties and the Debtor enjoy such an identity of interest that a lawsuit asserting talc-related claims against the Protected Parties is essentially a suit against the Debtor."
  - "The [Talc Claimants' Committee] states in its opposition that 'the claim of shared identities of interests is based solely on the allocation of agreements to the debtor on the eve of the bankruptcy filing for the very purpose of extending the stay.' …The Court is willing to accept that summarization and views it as a valid basis for extending the stay to the Protected Parties—not a reason to decline extension of the stay as advanced by the [Talc Claimants' Committee]."
  - "Given the facts of this case, the Court concludes that continued litigation against the Protected Parties would liquidate pending tort claims, as well as indemnification claims, against Debtor outside of chapter 11 and potentially deplete available insurance coverage—frustrating the purpose of the automatic stay."
- "[T]he Court concludes that 'unusual circumstances' are present warranting an extension of the automatic stay to Protected Parties under §362(a)(1) and (3). To the extent §362(a) does not serve as an independent basis for extension of the stay to the nondebtor parties, the Court determines that a preliminary injunction under § 105 extending the automatic stay is appropriate.
  - The Court will revisit continuation of the automatic stay and preliminary injunction in 120 days.
  - As to concerns that either party may "endeavor to 'run out the clock' … [l]et's be clear, the only clock of import sits on the Court's desk in Chambers and shows 1,869 days until retirement. The Court is confident that it can outlast either side's efforts to slow-walk the proceedings and will not countenance such conduct."
- This Decision is also subject to Direct Appellate Review by the Third Circuit.

DBMP Chapter 11 Case — Issue 3—Is There A Fraudulent Transfer In A Texas Two Step?

- In an adversary proceeding in the *In re DBMP LLC* chapter 11 case in the Western District of North Carolina, the Official Committee of Personal Injury Claimants was granted derivative standing to bring a fraudulent transfer claim to avoid the divisional merger effected in accordance with the Texas Business and Organizations Code. The Defendants moved to dismiss.
  - Defendants' position
    - "[T]here is no viable estate claim. The Amended Complaint is brought on 'behalf of the estate of the debtor … and seeks to avoid the Corporate Restructuring … as an intentional or constructive fraudulent transfer. Yet, critically, Plaintiffs fail to identify any single transfer of property by [the Debtor] or debt incurred by [the Debtor] that they seek to avoid."
    - While Plaintiffs decry the actions taken by [the dissolved pre-divisional merger entity] – authorized and implemented in accordance with the TBOC—[the dissolved pre-divisional merger entity] is not a debtor in this case.
  - Plaintiff's response
    - "To paraphrase Judge Chapman, there is a long history of lawyers using clever strategies like the 'Texas Two-Step' in an attempt to outflank statutory purpose and legislative intent. Such efforts should not be countenanced, as fraudulent transfer laws are intended to be interpreted broadly to ensure that they are not so easily circumvented. Further, one of the primary authors of the Texas divisional merger statute stated that the use of the statute as a strategy to impact the rights of creditors should be subject to challenge as a fraudulent transfer."
    - "[P]roperty of the estate should be interpreted broadly under the Bankruptcy Code, and includes, for example, assets that would have been property of the estate but for the transfer."
    - "[T]he definition of 'transfer' is to be interpreted as broadly as possible, and therefore a transfer under the Bankruptcy Code thus includes transactions that terminate an entity's rights to certain assets. Moreover, there was clearly an incurrence of obligations by [the Debtor] when it was allocated all of [the dissolved pre-divisional merger entity's] asbestos liabilities."

DMBP Chapter 11 Case — Issue 3 Cont.—The Fraudulent Transfer Count Survived The Motion To Dismiss.

- At a July 7, 2022 hearing, the Bankruptcy Court denied the Motion to Dismiss, rejecting the defendants' argument that the allocation of assets and liabilities under the TBOC's divisional merger statute was not a "transfer" that can be avoided.
  - "I think we have an adequate complaint here."
  - "I'm aware of the plain meaning of 'transfers' under the Bankruptcy Code, but plain meaning is subject to absurd results and that's the exception to plain meaning."
  - The judge noted that if the divisional merger can separate the assets and liabilities into a Goodco and Badco without any party being able to sue, the "door's open to wholesale fraud."
  - The Court went on: "This cannot be the aim of the Texas Merger Statute, which is intended to be creditor-neutral, and would run counter to all Anglo-American notions of fraudulent conveyance law."
  - Regarding DBMP's solvency, the Court stated, "We know it was designed not to be too solvent" because otherwise there would be "no need for the affiliates to come to the rescue."

DBMP Chapter 11 Case — Issue 4 — Can The Debtor and Non-Debtor Entities Be Substantively Consolidated?

- Also in an adversary proceeding in the DBMP Chapter 11 case, the Official Committee of Personal Injury Claimants sought a judgment retroactively substantively consolidating the Debtor with the non-debtor entity that was also formed in connection with the divisive merger.
  - Committee's position
    - Through the Texas Two Step the companies within the enterprise "have sought to isolate their asbestos liabilities from profitable operating businesses and to single out asbestos victims for unfair and discriminatory treatment by breaking [the company formerly holding both assets and liabilities] into separate corporate entities …. In contrast [to the Debtor, the non-debtor entity formed in the divisive merger] is outside of bankruptcy and is paying its (non-asbestos) unsecured creditors in the ordinary course of business … [and is] also free to pay its equity holders ahead of asbestos claimants, potentially to the tunes of millions of dollars…. Substantive consolidation will rescind the structural subordination of asbestos creditors that the Debtor and its cohorts have put in place through the Corporate Restructuring, ensuring that asbestos creditors will once again be *pari passu* with other unsecured creditors and have priority over equity holders ….
  - Defendant's position
    - "The Bankruptcy Code has no provision that authorizes the substantive consolidation of a non-debtor, and Plaintiffs cannot use Bankruptcy Code Section 105(a) to achieve that unauthorized end…. Even if substantive consolidation could apply to a non-debtor … the Complaint fails to allege [that] creditors dealt with the [two companies] as a single economic unit and did not rely on their separate identity in extending credit or … that the affairs of the [two companies] are so entangled … that substantive consolidation will benefit all creditors of both entities." The Defendants also asserted that the fraudulent transfer claim that the Committee was pursuing provided an alternative available remedy rendering enlisting the extraordinary remedy of last resort of substantive consolidation a misuse of judicial and estate resources.
- The Court denied a motion to dismiss the substantive consolidation count.

MAKE-WHOLE PREMIUMS

Typical Make-Whole Premiums

- Certain States prohibit voluntary prepayment of fixed maturity term debt without lender consent.
- Debt instruments
  - Often provide that they cannot be prepaid without a premium, such as a "make-whole" premium. If prepayment are allowed at all
- A "make-whole" premium
  - NPV calculation discounting payments that would have been received
  - calculated based on comparable treasury yields (see general calculation on slides 20, 21)

Typical Make-Whole Premiums (Cont'd)

- Most debt instruments provide that the debt may not be prepaid except with a make-whole premium.
- Some debt instruments provide that the debt can be automatically accelerated if the borrower files for bankruptcy
- Different instruments can be treated differently.
  - Investment grade bonds
  - High-yield bonds
  - Syndicated term loan

Make-Whole Premiums Outside Bankruptcy

- Generally, make-whole premiums are enforceable under typical state laws
  - Some are analyzed under liquidated damages provisions
  - Damages are difficult to determine in advance
- Courts increasingly defer to negotiations between the parties

Make-Whole Premiums Inside Bankruptcy

Key Inputs Used Within Make-Whole Call Provision NPV Calculation

$$\mathbf{V}_{\text{coupons}} = \sum \frac{C}{(1+r)^t}$$

$$\mathbf{V}_{\text{face value}} = \frac{F}{(1+r)^T}$$

- **C** = Future cash flows. In the context of a bond, these are the coupon payments.
- **r** = Discount rate. In the context of a make-whole call provision, the discount rate is determined by adding the yield of a similar maturity Treasury and the agreed upon make-whole spread. For example, if the bond issued has a maturity of ten years, the calculation would likely reference the 10-year Treasury yield.
- **F** = Face value of the bond.
- **t** = Number of periods.
- **T** = Time to maturity.

Make-Whole Premiums Inside Bankruptcy

Key Inputs Used Within Make-Whole Call Provision NPV Calculation

$$\mathbf{V_{coupons}} = \sum \frac{C}{(1+r)^t}$$

$$\mathbf{V_{face\ value}} = \frac{F}{(1+r)^T}$$

- **F** = $1,000
- **C** = $25 per period (2.5% x $1,000)
  - **Coupon Rate (semi-annual)** = 2.5% (In this example, the borrower makes semi-annual payments. The annual coupon rate is 5%.)
- **t** = 4 periods (2 years x 2 semi-annual coupon payments)
- **T** = 4 periods
- **r** = 3.0% or 1.5% for semi-annual (The 3.0% discount rate assumes a 2.5% 2-year Treasury Yield and a make-whole spread of 50bps (0.5%))

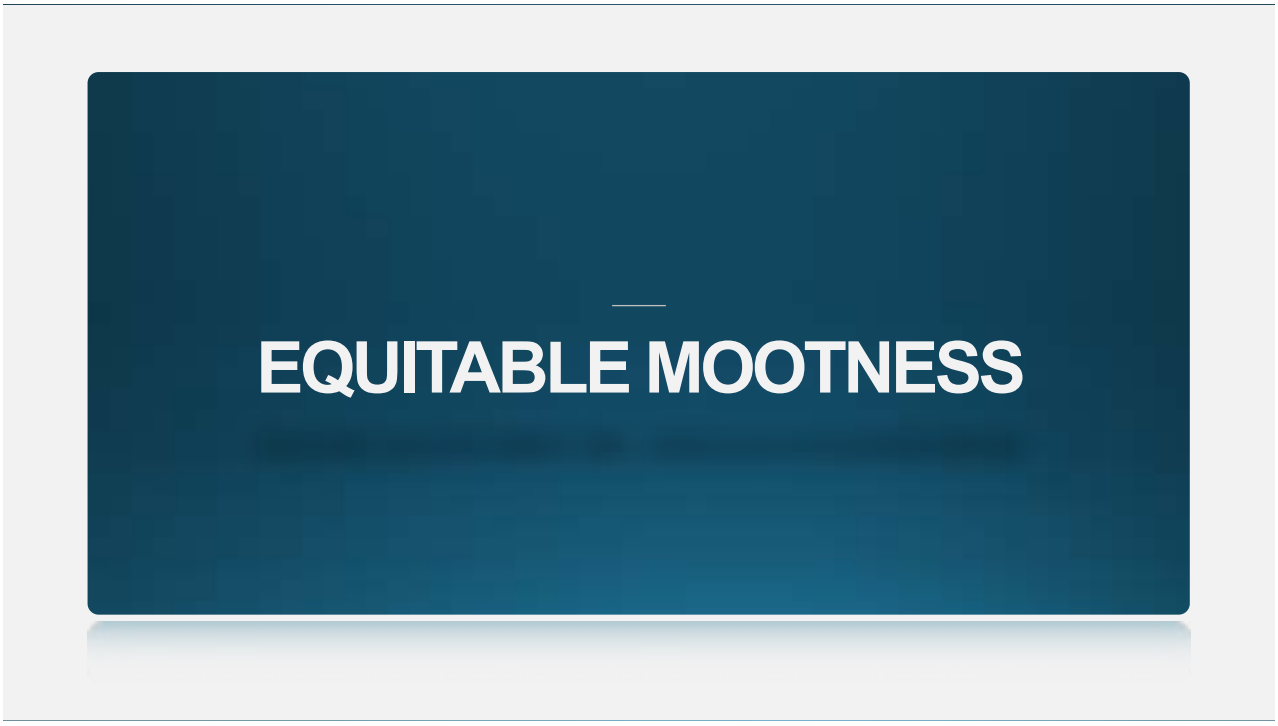
Present Value of Semi-Annual Payments

$$\frac{25}{(1.015)^1} + \frac{25}{(1.015)^2} + \frac{25}{(1.015)^3} + \frac{25}{(1.015)^4} = 96.36$$

Present Value of Face Value

$$\frac{1000}{(1.015)^4} = 942.18$$

Value of Bond = $1,038.54



Equitable Mootness

- "Equitable Mootness" is a court-created doctrine that limits appeals of bankruptcy court orders
  - Its application is limited, and it most notably relates to chapter 11 plan confirmation orders, though some courts have extended its application to orders related to a sale of a debtor's property, orders regarding cash collateral, and even settlements and distributions in chapter 7 cases
- Equitable mootness bears no relationship to constitutional mootness
  - Constitutional mootness occurs where the parties involved lack an interest in the outcome, making the issue "moot."
  - On the other hand, equitable mootness applies when a court is unwilling to provide the requested relief on the basis that overturning the confirmation order would be impractical and harm those who relied on implementation of the plan
  - Equitable mootness protects settlements and resolutions of various issues made in a plan of reorganization against appellate challenge

Equitable Mootness

- Since its inception out of the Ninth Circuit in 1981, all circuits have adopted some form of equitable mootness, differing slightly on the factors considered
  - *In re Roberts Farms, Inc*., 652 F.2d 793 (9th Cir. 1981)
  - *In re Cont'l Airlines*, 91 F.3d 553 (3d Cir. 1996)
    - The Third Circuit, sitting *en banc*, developed the five-factor balancing test for analyzing equitable mootness
  - *In re Charter Commc'ns, Inc.*, 691 F.3d 476 (2d Cir. 2012)
    - The Second Circuit found that the doctrine of equitable mootness applies if the debtor's plan of reorganization has been "substantially consummated"
  - *In re Semcrude, L.P.,* 728 F.3d 314 (3d Cir. 2013)
    - The Third Circuit adopted a more nuanced analysis than the previous five-part test
  - *In re Transwest Resort Props., Inc*., 801 F.3d 1161 (9th Cir. 2015)
    - The Ninth Circuit established its reliance on a four-factor test to analyze equitable mootness

Equitable Mootness

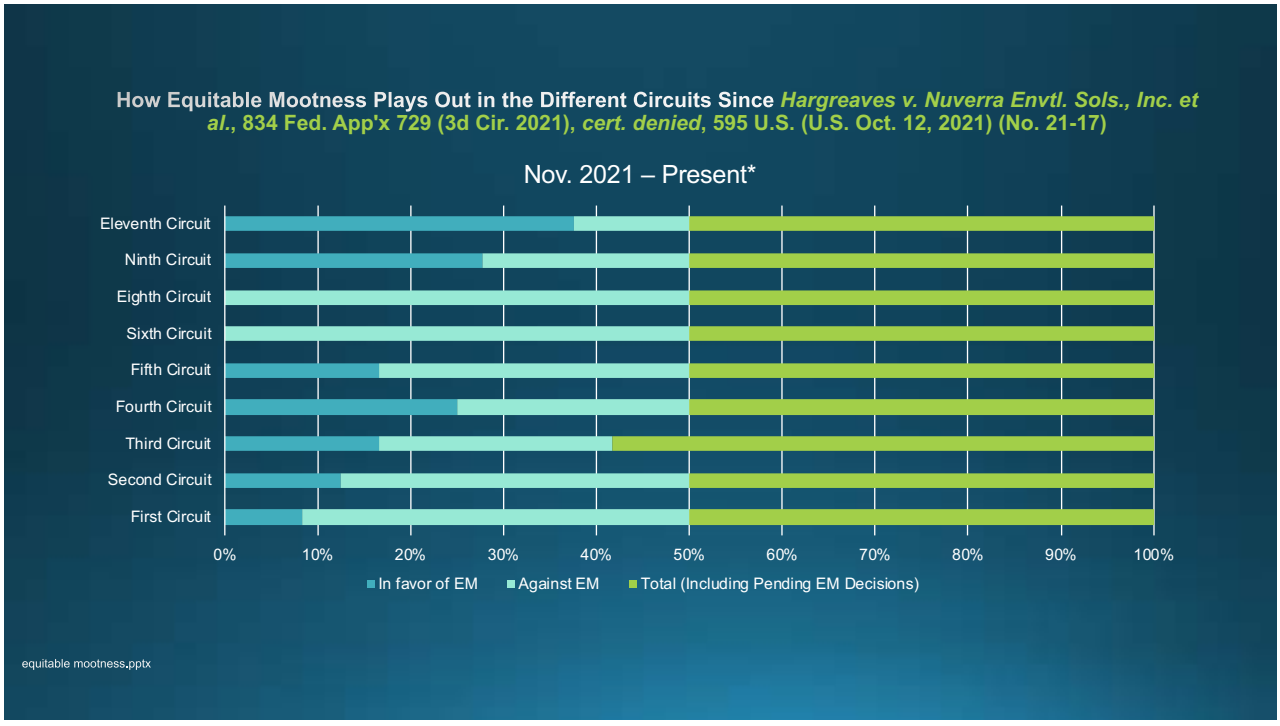
- In general, all circuits try to answer the same question of whether it is prudent to upset the plan of reorganization at the relevant stage
- If a court considers these issues and determines the appeal of the confirmation is equitably moot, it will dismiss the appeal without determining whether the basis for the appeal is meritorious.
- In addition to applying different standards for application of equitable mootness, circuit courts are split with respect to the scope of equitable mootness and equitable considerations regarding who it is intended to protect

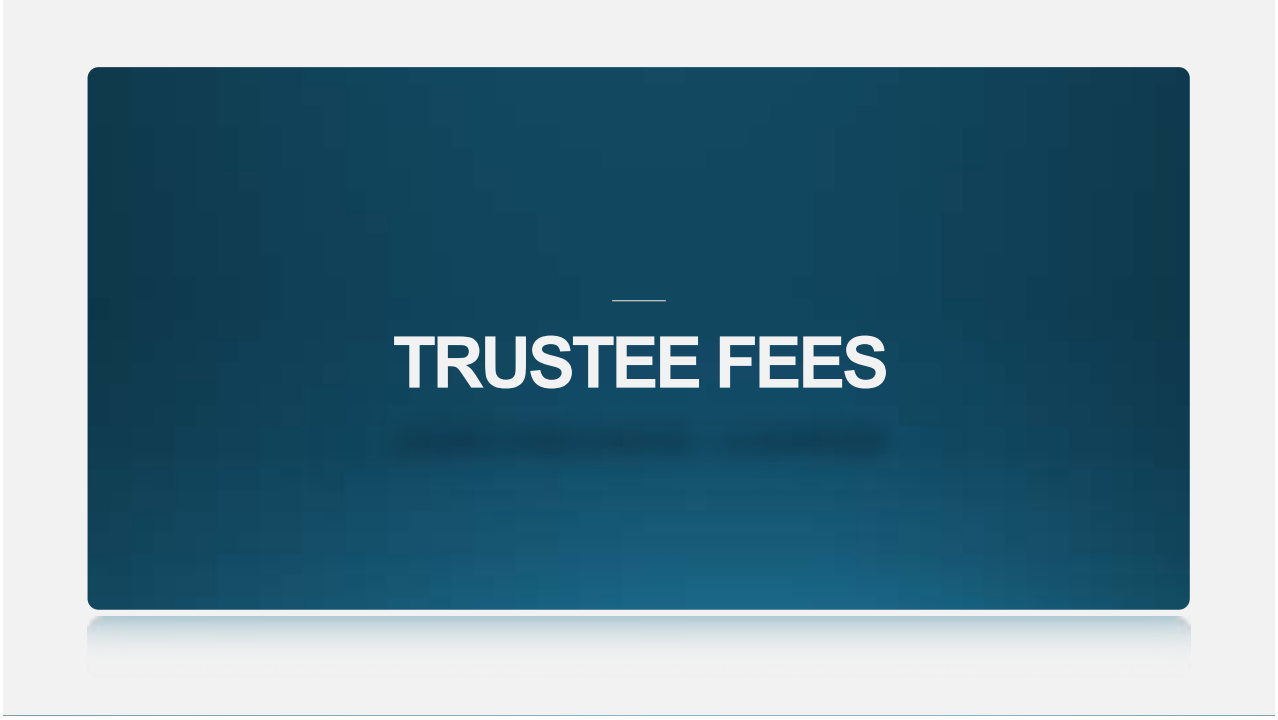
Challenges to Equitable Mootness

- Within the last decade, the doctrine of equitable mootness has been called into question for a few reasons.
  - Although the doctrine is meant to be applied sparingly, it has been invoked in noncomplex cases or cases where limited relief is practicable.
  - In addition, some have challenged the doctrine on the basis that Bankruptcy Judges are not Article III Judges and appellate review by an Article III Judge (i.e., a District Court Judge) is important to the determination of whether Bankruptcy Judges have encroached upon the power reserved for Article III Judges
- See, e.g., *In re One2One Commc'ns, LLC*, 805 F.3d 428 (3d Cir. 2015).
  - This case is notable in part for its concurrence, which was a criticism of the equitable mootness doctrine. Judge Krause noted that "district courts have continued to invoke the doctrine in modest, non-complex bankruptcies and where appellants have sought limited relief." 805 F.3d at 7.

Petitions for Certiorari

- There have been numerous petitions for writs of certiorari filed in the last year related to the doctrine of equitable mootness
- Given the volume of recent cases considering the issue in many circuits and the splitting of judicial opinions supporting and critiquing the implications of equitable mootness, this issue is ripe for consideration by the Supreme Court
- The Supreme Court has not granted any petition for writs of certiorari related to equitable mootness at this time
- Most recently, on June 6, 2022, SCOTUS denied a petition for a writ of certiorari in the case of KK-PB Financial, LLC v. 160 Royal Palm LLC





Executive Summary

- On June 6, 2022, the Supreme Court issued an opinion regarding whether Congress could enact a non-uniform fee increase in view of the Constitution's requirement that Congress enact "uniform Laws on the subject of Bankruptcies throughout the United States" (the "Bankruptcy Clause")
- In a 9-0 decision, the Supreme Court held that Congress' scheme of allowing non-uniform fees was unconstitutional
- The Court's holding leaves open the possibility for debtors that paid trustee fees between January 1, 2018 and January 1, 2021 to seek a refund for overpayments

A History

- The U.S. Trustee program, which is part of the U.S. Department of Justice, oversees bankruptcy administration in 88 of the 94 federal districts. *See* 28 U.S.C. § 581(a)
- In the 1980s, Congress tried establishing a nationwide U.S. Trustee program to help Bankruptcy Courts administer cases, but allowed six districts in North Carolina and Alabama to continue using their own "Administrator" program
- The "Trustee" program and "Administrator" program were substantively similar in function
- The "Trustee" program was funded by quarterly trustee fees paid by debtors, whereas the "Administrator" program was funded by the judiciary's general budget

A History

- Most of the money in the United States Trustee System Fund comes from quarterly fees paid by debtors in UST Districts pursuant to 28 U.S.C. § 1930(a)(6)
- Section 1930(a)(6)(A) provides in relevant part:

> *"[A] quarterly fee shall be paid to the United States trustee ... in each case under chapter 11 of title 11 ... for each quarter (including any fraction thereof) until the case is converted or dismissed, whichever occurs first."*

A History

- Initially, only debtors in UST Districts paid quarterly fees. The "Administrator" program, on the other hand, was funded by the judiciary's general budget
- In 1994, however, the Ninth Circuit held that the absence of quarterly fees in Administrator districts was unconstitutionally non-uniform.
- Congress then enacted § 1930(a)(7) to provide for corresponding quarterly fees in Administrator districts.
  - These funds offset appropriations to the judicial branch
- This parity remained in place until the first quarter of 2018, when the 2017 Amendment took effect in the UST Districts.

The 2017 Amendment

- In 2017, Congress amended the fee statute to tie the amount of quarterly fees a debtor pays to the size of its disbursements, *i.e.*, to the amount that the debtor pays to third parties.
  - The larger the disbursement, the larger the quarterly fee.
- The Amendment states as follows:

> *"During each of fiscal years 2018 through 2022,if the balance in the United States Trustee System Fund as of September 30 of the most recent full fiscal year is less than $200,000,000, the quarterly fee payable for a quarter in which disbursements equal or exceed $1,000,000 shall be the lesser of 1 percent of such disbursements or $250,000."*

The 2017 Amendment

- In 2017, Congress passed a law raising quarterly U.S. Trustee fees paid in large chapter 11 cases
  - The fee increase went into effect if the UST fund fell below a certain amount, and applied to both new and pending cases
  - The law gave the "Administrator" programs discretion on whether to adopt the new fee increases
- The six districts in the "Administrator" program did not immediately adopt the 2017 fee increase but in 2018 adopted the increased fees for new cases starting from October 1, 2018

	Trustee Program	Administrator Program
General Funding	Quarterly fees paid by debtors	Judiciary budget
2017 Act Fee Increases	Subject to conditions, took effect January 1, 2018 Applied to both pending and new cases	Took effect October 1, 2018 Applied only to new cases

Procedural History

- In 2010, the Bankruptcy Court for the Eastern District of Virginia approved Circuit City's plan of liquidation
- The plan contemplated that the debtors would continue paying quarterly U.S. Trustee fees until the cases were closed or converted
- Circuit City's cases were still pending when the 2017 fee increases took effect
- Across three quarters, Circuit City paid approximately $630k in fees, compared to $56k that it would have paid absent the fee increases
- Circuit City objected to the increased quarterly fees on the basis that non-uniform fees violated the Bankruptcy Clause, which requires that Congress enact "uniform Laws on the subject of Bankruptcies"

Procedural History (cont'd)

- The defendant/respondant argued that the 2017 fee increase was not a law "on the subject of Bankruptcies," but rather an administrative law
- The defendant further argued that the uniformity requirement applied only to laws that altered the substance of debtor-creditor relations
- From there, the issue was considered by the Courts:

Court	Holding
Bankruptcy Court for Eastern District of Virginia	Non-uniform fee increases violated Bankruptcy Clause; debtors permitted to pay fees at rate in effect before 2017 fee increase
Fourth Circuit Court of Appeals	Divided panel reversed; Bankruptcy Clause only forbid "arbitrary" geographic differences – Congress' efforts to remedy funding shortfall was not "arbitrary"

Circuit Split

- Courts in other jurisdictions reviewing the 2017 fee increase have been split:

Court	Holding
2nd Circuit	Fee increase violated Bankruptcy Clause (In re Clinton Nurseries, Inc., 998 F.3d 56 (2d Cir. 2021))
3rd Circuit	No circuit decision, but Delaware Bankruptcy Court found that fee increase did not violate Bankruptcy Clause (In re Exide Techs., 611 B.R. 21, 26 (Bankr. D. Del. 2020))
4th Circuit	Fee increase did not violate Bankruptcy Clause (In re Circuit City Stores, Inc., 996, F.3d 156, 160 (4th Cir. 2021)
5th Circuit	Fee increase did not violate Bankruptcy Clause (In re Buffets, LLC, 979 F.3d 366 (5th Cir. 2020))
10th Circuit	Fee increase violated Bankruptcy Clause (In re John Q. Hammons Fall 2006, LLC, 15 F.4th 1011, 1016 (10th Cir. 2021))
11th Circuit	Fee increase did not violate Bankruptcy Clause (In re Mosaic Mgmt. Grp., 22 F.4th 1291, 1327 (11th Cir. 2021))

Supreme Court Holding

- The Supreme Court held that neither the Bankruptcy Clause nor the Court's holdings have made a distinction between "substantive" and "administrative" bankruptcy laws
  - In any event, the Court noted that the U.S. trustee fees depleted estate resources, and therefore did in fact alter the "substance" of debtor-creditor relations
- The Court also held that Congress could not bypass the "affirmative limitations" of the Bankruptcy Clause by relying on other parts of the Constitution (for example, the "necessary and proper" clause)
- The Court also examined prior precedent and concluded that the Bankruptcy Clause did not permit arbitrary, disparate treatment of similarly-situated debtors based on geography
  - In *Moyses*, the Court affirmed constitutionality of state exemptions to bankruptcy laws because the general operation was uniform but led to particular results (e.g., the law was uniform in permitting state exemptions)

Supreme Court Holding

- In *Regional Rail Reorganization Act Cases*, the Court affirmed a law that applied to all railroads operating in the United States, even though all of those railroads were operating in a limited geographic area
- In *Gibbons*, the Court struck down a law when Congress altered the order of priorities for a single railroad's bankruptcy case
- As a corollary, the Court noted that Congress could pass "geographically limited laws consistent with the uniformity requirement if it is responding to a geographically limited problem"
- By contrast, the 2017 fee increases were not geographically uniform, and resulted in similarly-situated debtors in different states to pay different fees
- The Court gave no credit to the argument that Congress was trying to solve for the funding shortfall which supported states in the "Trustee" program
- The Court noted that the shortfall existed because Congress itself "arbitrarily separated the districts into two different systems with different funding mechanisms"

Supreme Court Holding

- The Court noted that its holding did not address the dual scheme of the bankruptcy system, and did not restrict Congress' authority to structure relief differently for different classes of debtors or to respond to geographically isolated problems
- The Court remanded the judgment to the Fourth Circuit to fashion an appropriate remedy

Takeaways

- Congress can pass bankruptcy laws that are uniform in nature but lead to non-uniform results
- Congress could also pass laws that are geographically limited, if responding to geographically limited problems
- Puerto Rico has a separate insolvency scheme that applies just to that territory – some commentators have suggested, before *Siegel*, that PROMESA might violate the Bankruptcy Clause
- From a practical perspective, debtors that paid the increased fees between 2018 and 2021 can likely get a refund for overpayments

Faculty

Brian Davies, CIRA is managing director of Capstone Partners in Boston and heads its financial advisory services (FAS) practice. He has approximately 20 years of professional experience in the fields of corporate recovery, business reorganization and interim-management services. Mr. Davies has provided financial advisory services to lenders, debtors, creditors' committees, trustees and equityholders in bankruptcy matters and out-of-court restructurings. He has provided assistance to under-performing businesses and potential acquirers of distressed assets/entities, and he has advised clients on general business issues. Mr. Davies also has advised and worked with financially distressed companies to develop cost-containment and asset-rationalization plans, improve liquidity, reengineer financial and other back-office functions, and enhance cash flow. His industry experience includes retail, security, e-commerce, real estate and housing, manufacturing, distribution, automotive, construction, hospitality, environmental testing laboratories, aviation, food/beverage, mining and health care. Mr. Davies has served as an operating partner in a leading global private-equity firm focused on management buyouts and recapitalizations of middle-market companies, as well as growth equity investments. His primary objective was managing all distressed/challenged operations of any portfolio company experiencing performance issues, liquidity concerns, covenant breaches, availability diminution, management voids and synergy attainment. Mr. Davies has served as an interim "C"-level manager, sat on the boards of portfolio companies, and partnered with deal teams on both buy- and sell-side diligence and negotiations, ensuring the portfolio companies are running efficiently and accreting maximum value through strategic planning, cost-cutting and operational assessments. While serving as a managing director and co-head of Mesirow Financial Consulting's New England Practice, Mr. Davies spearheaded national large-scale projects that ranged in size from $10 million to over $30 billion in total revenue, focusing on the overall turnaround of at-risk operations within diverse and industry-leading clientele platforms. He also coordinated on full project lifecycles, including planning, budgeting, reporting, field operations, negotiations, contract administration and risk management. Mr. Davis is a member of the Association of Insolvency & Restructuring Advisors and has received Banker of the Year and Restructuring of the Year awards several times. He received his B.S. in finance from Bentley University and his M.S. in finance from Bentley University McCallum Graduate School of Business.

D. Ethan Jeffery is a shareholder with Murphy & King, PC in Boston, where he focuses his practice on representing debtors, trustees and creditors in complex chapter 11 cases, and the representation of debtors and creditors in nonbankruptcy restructurings and workouts. He has represented debtors, creditors committees, and secured and unsecured creditors in bankruptcy and other insolvency proceedings in courts in most states along the Atlantic seaboard. Mr. Jeffery represents plaintiffs and defendants in commercial litigation in bankruptcy proceedings and other litigation matters relating to the debtor-creditor relationship. He is a member of the American and Boston Bar Associations and ABI, and is chairman of the Massachusetts Clients' Security Board. Mr. Jeffery is a faculty member of Massachusetts Continuing Legal Education, Inc. and is admitted to practice in Massachusetts, Pennsylvania, the U.S. District Courts for the Districts of Massachusetts and New Jersey and the Eastern District of Pennsylvania, and the U.S. Courts of Appeals for the First and Third Circuits. He received his B.A. in 1987 from the University of New Hampshire and his J.D. in 1991 from Villanova Law School.

Hon. David S. Jones is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Feb. 19, 2021. He previously clerked for Hon. Morris E. Lasker, U.S. District Judge for the Southern District of New York, from 1990-92, and was in private practice in New York from 1992-96. From 1996 until he was appointed to the bench, Judge Jones served as an Assistant U.S. Attorney for the Southern District of New York, and at different times served as the chief of the U.S. Attorney's Office's Tax and Bankruptcy Unit, the Office's chief civil appellate attorney and as deputy chief of the Civil Division. He was awarded the Justice Department's Director's Award and the New York City Bar Association's Henry L. Stimson Medal, among other awards. Judge Jones also served as an instructor at the National Advocacy Center, and as an evaluator of U.S. Attorney's Offices throughout the nation. He received his A.B. *magna cum laude* from Brown University in 1985 and his J.D. *cum laude* from Harvard Law School in 1990.

John J. Monaghan is a partner in Holland & Knight LLP's Boston office and serves as the co-national practice group leader of the firm's Bankruptcy, Restructuring and Creditors' Rights Practice Group. He is particularly focused on representing major case participants in complex commercial insolvency and restructuring matters, with a particular focus on chapter 11 cases. Mr. Monaghan represents both U.S.-based companies as debtors in chapter 11 and non-U.S. companies in both in-court and out-of-court cross-border insolvency proceedings. His creditor representations focus on matters involving senior lenders, both in syndicated and single-lender deals, and he has experience representing creditors' committees, equity committees, purchasers of assets, landlords, licensors, trustees, parties to pre-petition contracts and leases, defendants in adversary proceedings and unsecured creditors. Mr. Monaghan's experience crosses a broad array of industries, including finance, manufacturing, real estate, technology, telecommunications, retail, health care, resort and hospitality, franchise, food service, leasing, maritime and aviation. His experience includes advising for-profit and non-profit boards in connection with governance issues, as well as in litigating director and officer fiduciary duty issues for estate representatives and for directors and officers. Mr. Monaghan's litigation experience also includes defending and prosecuting fraudulent transfer and other avoidance actions, as well as numerous cross-border insolvency proceedings centered in a number of countries, and he has represented companies or creditors in cases centered in Singapore, the U.K., Canada, Switzerland, Greece, the Caribbean, Bermuda, Brazil, the Czech Republic, Taiwan and other countries in matters involving shipping, finance, aviation, energy, manufacturing and hospitality companies. Mr. Monaghan has been named a top bankruptcy lawyer by numerous ranking publications, and in 2008, he was inducted as a Fellow in the American College of Bankruptcy. In 2010, he was named as a Fellow of the American Bar Foundation (ABF), and he was named to the International Insolvency Institute (III) in 2016. A frequent lecturer on bankruptcy issues, Mr. Monaghan has presented seminars on the Bankruptcy Code safe harbors for financial industry transactions, constitutional issues arising from the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), litigating contested plan confirmation proceedings, the purchaser's perspective in transactions with a chapter 11 debtor, cross-border issues in energy industry insolvencies, and maritime insolvency issues for organizations including ABI, the National Conference of Bankruptcy Judges, the International Bar Association, Marine Money and the Association of Insolvency and Restructuring Advisors. He received his B.A. *cum laude* from Middlebury College and his J.D. *cum laude* from Boston University School of Law.

Cristine Pirro Schwarzman is a restructuring partner in Ropes & Gray LLP's New York office. Previously, she worked as the term clerk for Chief Judge Gonzalez of the Southern District of New

York, then joined the restructuring group of another preeminent New York law firm. Ms. Schwarzman represents debtors, lenders and investors, including private-equity sponsors, in connection with acquisitions, out-of-court restructurings and chapter 11 cases. She also advises boards of directors and senior management of distressed companies regarding fiduciary duties and corporate governance. Ms. Schwarzman is a member and prior board member of the International Women's Insolvency & Restructuring Confederation and a member of the Local Bankruptcy Rules Committee for the Southern District of New York. She received her B.A. *cum laude* from the University of Pennsylvania in 2007 and her J.D. in 2010 from the University of Pennsylvania Law School, as well as a Certificate in Business Economics and Public Policy from the Wharton School of the University of Pennsylvania, where she was a teaching fellow with the Marshall Brennan Constitutional Law Literacy Project.