AMERICAN BANKRUPTCY INSTITUTE

Views from the Bench, 2017

Confirmation Roundtable

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ABI Bankruptcy 2017: Views from the Bench Confirmation Topics

Skadden

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Introduction – Today's Program

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Legal Status of Plan of Reorganization – *In re Molycorp, Inc.*

Contractual Subordination and Cramdown – *TCI 2 Holdings, Tribune & Croatan*

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Rejecting Prepetition Contracts After Confirmation – *In re Triangle USA Petroleum Corp.*

Cramdown Valuation – *In re Sunnyslope*

Post-Default Interest Rates – *In re New Investments, Inc*

Panelists

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* The views expressed in this presentation do not necessarily represent the views of the judges. Nothing the judges say today may be construed as binding them to any legal position or commentary on the direction their courts may take in the future.

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Legal Status of Plan of Reorganization – *In re Molycorp, Inc.*

Legal Status of Plan of Reorganization – Overview and Applicable Bankruptcy Code Provisions

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- What is the legal status of a confirmed plan of reorganization?
  - Is it a contract governed by state law contract principles and, for purposes of pre-judgment interest, state law rules?
  - Or is a confirmed plan instead governed by federal pre-judgment interest principles and res judicata principles unique to bankruptcy?
- Bankruptcy Code section 1129(a)(9)(A) provides that, unless agreed otherwise, each holder of an administrative claim, such as allowed professionals' fees, will receive "cash equal to the allowed amount of such claim" on the effective date of the plan.
- Does a standard carve-out in a financing order for the fees of counsel and other professionals for an official creditors' committee limit the ability of such professionals to be paid in full under a confirmed plan pursuant to Bankruptcy Code section 1129(a)(9)(A)?

Legal Status of Plan of Reorganization – *Molycorp* Background

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- Facts of *In re Molycorp, Inc.*, 562 B.R. 67 (Bankr. D. Del. 2017):
  - The debtors' confirmed plan incorporated a global settlement agreement among the debtors, a DIP lender, and the creditors' committee.
  - After confirmation, the DIP lender filed an objection to the committee's counsel's request for fees, asserting that the compensation requested was incurred in violation of a fee cap included in the DIP order.
  - Because the committee had long since exhausted the fee cap in the DIP order, the DIP lender contended that there was no money left to be dispersed without rendering the cap in the DIP order meaningless.
  - In contrast, the committee's counsel argued that the cap in the DIP order had no bearing on the payment of administrative claims after the plan had been confirmed.

Legal Status of Plan of Reorganization – *Molycorp* Holding

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- The court granted the committee's fee application.
  - The court held that absent specific language in the DIP order, a dollar-amount cap on professionals' fee payment, or a carve-out, does not come into play once a Chapter 11 plan is confirmed.
  - In deciding this issue, the court relied on Bankruptcy Code section 1129(a)(9)(A), which the court described as "a fundamental statutory requirement of the Bankruptcy Code," noting that standard carve-outs do not supersede the requirement to pay administrative claims, such as allowed professionals' fees.
- This holding indicates that a confirmed plan is better understood as governed by federal pre-judgment interest principles and res judicata principles unique to bankruptcy, rather than as governed by state law contract principles and rules.

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Contractual Subordination and Cramdown – *TCI 2 Holdings, Tribune & Croatan*

Contractual Subordination and Cramdown – Applicable Bankruptcy Code Provisions and Overview

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- Bankruptcy Code section 1129(b) provides that a debtor can "cramdown" a plan of reorganization over the dissent of certain creditors only if the plan "does not discriminate unfairly, and is fair and equitable … notwithstanding section 510(a) of this title."
- Bankruptcy Code section 510(a) provides for the enforceability of contractual subordination in bankruptcy to the same extent the subordination would be enforceable under nonbankruptcy law.
- Few cases have discussed the precise meaning of this carve out of section 510(a) from section 1129(b), though three recent opinions have provided more clarity by not enforcing the subordination agreements at issue:
  - *In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010)
  - *In re Tribune Co.*, 464 B.R. 126 (Bankr. D. Del.)
  - *In re Croatan Surf Club, LLC*, No. 11-00194-8-SWH, 2011 WL 5909199 (Bankr. E.D.N.C. Oct. 25, 2011)

Contractual Subordination and Cramdown – *TCI 2 Holdings, Tribune, & Croatan*

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- In all three of these cases, the courts held that a bankruptcy court may confirm a cramdown plan which disrupts bargained for priority, and thus is inconsistent with the terms of a subordination or intercreditor agreement, as long as it is fair and equitable and does not discriminate unfairly.
- In *TCI 2 Holdings*, Judge Wizmur explained that the only logical reading of the term "notwithstanding" in section 1129(b)(1) is as follows:
  - "Even though section 510(a) requires the enforceability of subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the § 1129(a) and (b) requirements, the court shall confirm the plan."
  - Accordingly, the phrase "[n]otwithstanding section 510(a) of this title" removes section 510(a) from the scope of 1129(a)(1), which requires compliance with "the applicable provisions of this title."
- This reasoning was echoed and expanded on by the courts in *Tribune* and *Croatan*.
  - For example, the court in *Croatan* noted that § 510(a) was not intended to give parties carte blanche to override other provisions of the Bankruptcy Code, and accordingly disregarded the subordination provisions at issue when considering whether to confirm the nonconsensual plan.

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Frontloading Notice in Prepacks – *In re Roust Corp.*

Frontloading Notice in Prepacks – Background of *In re Roust Corp.*

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- In early January 2017, less than a week after its bankruptcy filing, Roust Corporation was able to confirm its prepackaged plan of reorganization in the U.S. Bankruptcy Court for the Southern District of New York.
- Facts:
  - The debtors commenced solicitation approximately 30 days prior to the bankruptcy filing by mailing a notice of a combined hearing on standard first day motions, the adequacy of the disclosure statement, and confirmation of the plan to all of their known creditors and interest holders of record.
  - Prior to the hearing, the United States Trustee objected to plan confirmation, arguing that the case was a "prepetition bankruptcy case" designed to avoid scrutiny and the procedural protections of the bankruptcy process.

Frontloading Notice in Prepacks – Confirmation of *In re Roust Corp.*

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- In confirming the case on such a compressed time frame and overruling the United States Trustee's objection, Judge Drain held that the 28-day notice period for confirming a Chapter 11 plan could run coextensively with the period under which creditor votes on the plan were solicited prior to the commencement of the bankruptcy case.
  - Judge Drain noted while the bankruptcy rules provide for 28 days' notice, they do not require 28 days' notice after the petition date; instead, the notice period can commence prepetition.
  - Judge Drain also considered the fact that all key constituencies in the cases were sophisticated parties who had ample opportunities to review the solicitation documents.
  - Further, no party holding an economic interest had objected to confirmation of the debtors' plan.

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Rejecting Prepetition Contracts After Confirmation – *In re Triangle USA Petroleum Corp.*

Rejecting Prepetition Contracts After Confirmation – Background of *In re Triangle USA Petroleum Corp.*

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- In a recent groundbreaking ruling in the *Triangle USA Petroleum Corp*. case, Judge Walrath confirmed a plan that permitted the debtor to reject a pre-bankruptcy contract well after its case ended, despite concerns that the decision would inspire other post-confirmation exploits.
- Facts:
  - The contract at issue was a fixed-price pipeline contract set at rates prevailing before oil and gas prices sharply fell.
  - The debtor was unable to reject the contract during the course of the bankruptcy because it required a ruling from a North Dakota court on
    - (i) its right to break the agreement (through a holding that the contract does not contain covenants that run with the land), and
    - (ii) a finding that cancellation damages would cost $75 million or less.
  - Clarifying such issues could take months or years.

Rejecting Prepetition Contracts After Confirmation – Holding of *In re Triangle USA Petroleum Corp.*

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- The plan proposed a "conditional rejection" of the contract that was accompanied by a "toggle" provision that would make the rejection permanent based on the outcome of the North Dakota litigation.
  - If the contract is rejected, then Caliber would be entitled to a $75 million rejection damages claim, which effectively served as a cap on Caliber's damages.
- Judge Walrath noted that though this provision was unusual, she did not believe that it was prohibited by the Bankruptcy Code.
- The court's holding was also narrowly limited to the specific facts of this case:
  - Judge Walrath noted that the option to reject the contract post-confirmation was tied to the pending litigation, and that if such litigation did not exist, then the "toggle" option would be less persuasive.
  - According to Judge Walrath, such a limitation "takes it out of the 'barn door is thrown open' category."

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Cramdown Valuation – *In re Sunnyslope*

Cramdown Valuation – Applicable Bankruptcy Code Provisions and Valuation Overview

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- Bankruptcy Code section 506(a)(1) controls the extent to which a creditor's claim is secured in the cramdown context. Pursuant to this provision, the value of such claim is "determined in light of the purpose of the valuation and of the proposed disposition or use of such property."
- Courts have employed several different valuation methods for collateral in this context, each of which results in a different value for the collateral.
  - Foreclosure value is determined by the net amount the creditor would receive upon foreclosure and a subsequent sale of the asset.
  - Replacement value is calculated by determining how much the debtor would have to pay to purchase a "like" asset.
  - The so-called "split-the-difference" approach uses the midpoint of both valuations.

Cramdown Valuation – *In re Sunnyslope*

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- Facts of *In re Sunnyslope Hous. Ltd. P'ship*, 859 F.3d 637 (9th Cir. 2017):
  - Sunnyslope, the debtor, owned an apartment complex in Arizona.
  - In order to secure financing and tax benefits, the debtor agreed to covenants which required that the property be used for affordable housing. These restrictive covenants terminated on foreclosure.
  - After the debtor defaulted on the loan at issue, First Southern National Bank began foreclosure proceedings. A receiver was appointed and ultimately agreed to sell the property to a third party for $7.65 million.
  - However, before the sale closed, Sunnyslope filed a Chapter 11 petition and sought to retain the complex by exercising the cramdown option over First Southern's objection.

Cramdown Valuation – *In re Sunnyslope*

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- Lower court decisions in *Sunnyslope*:
  - The primary dispute of Sunnyslope's reorganization proceedings became the valuation of the collateral, specifically, whether the property should be valued with or without regard to the restrictive covenants.
  - A valuation of the property that contemplated continued use of the complex for low-income housing (in accordance with the restrictive covenants) resulted in a valuation of $3.9 million.
  - On the other hand, if the covenants were disregarded, the property could be valued at more than $7 million.
  - The bankruptcy court confirmed the plan at the $3.9 million valuation and the district court affirmed.
  - On appeal, the Ninth Circuit reversed the lower court's decision. The panel held that the apartment complex should have been valued without regard to the covenants.
  - Ultimately, the case was granted a rehearing en banc.

Cramdown Valuation – *In re Sunnyslope* and *Assocs. Commercial Corp. v. Rash*

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- Upon rehearing, the Ninth Circuit held that the bankruptcy court did not err in valuing First Southern's collateral by assuming its continued use as affordable housing, thus rejecting the attempt to use foreclosure value, rather than replacement value, even though the latter resulted in a lower valuation.
- In so holding, the Ninth Circuit relied heavily on the Supreme Court's decision in *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953 (1997).
  - In *Rash*, the Supreme Court was unequivocal in stating that under section 506(a), the value of the property retained in a cramdown is "the cost the debtor would incur to obtain a like asset for the same proposed . . . use."
- The Ninth Circuit stated that Rash requires one to determine the price that a debtor in the same position would pay to obtain an asset like the collateral for the "particular use proposed in the plan."
- Therefore, replacement value was the appropriate methodology rather than foreclosure value, as the plan was designed to avoid foreclosure.

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Post-Default Interest Rates – *In re New Investments, Inc*

Post-Default Interest Rates – *Entz-White* and Applicable Bankruptcy Code Provisions

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- Chapter 11 allows for the curing or waiving of any contractual default to provide adequate means for a plan's implementation.
- In *In re Entz-White Lumber & Supply, Inc.*, 850 F.2d 1338 (9th Cir. 1988), the Ninth Circuit held that a debtor who cures a default is entitled to avoid all consequences of the default, including the imposition of higher post-default interest rates, even when the underlying agreement provides for the payment of interest at such higher rates.
- *Entz-White* was decided in 1988, before the 1994 amendments to the Bankruptcy Code were enacted.
- Those amendments included the addition of Bankruptcy Code section 1123(d), which in relevant part states that "if it is proposed in a plan to cure a default the amount necessary to cure . . . shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law."

Post-Default Interest Rates – Facts of *In re New Investments, Inc*

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- Facts and Bankruptcy Court Decision in *In re New Investments, Inc*, 840 F.3d 1137 (9th Cir. 2016):
  - The debtor, New Investments, borrowed approximately $3 million from Pacifica to purchase a hotel.
  - The agreement provided for an interest rate of 8% and, in the event of a default, the rate would increase by 5%.
  - New Investments defaulted on the note. When Pacifica attempted to foreclose on the property, New Investments filed for bankruptcy under Chapter 11.
  - New Investments' plan of reorganization proposed curing the default by selling the property and using the proceeds to pay Pacifica at the pre-default interest rate.
  - Pacifica objected to this proposed cure, arguing that it should receive payment at the post-default interest rate.
  - The bankruptcy court confirmed the plan over Pacifica's objection and authorized the sale, and Pacifica appealed.

Post-Default Interest Rates – Ninth Circuit Opinion in *In re New Investments, Inc*

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- On appeal in the Ninth Circuit, the court held that to effectuate a cure, a debtor must pay the amount owed to the creditor at the post-default interest rate, thereby overruling *Entz-White.*
- Examining both of the sources mentioned in Bankruptcy Code section 1123(d) (namely, the promissory note and Washington state law), the Ninth Circuit stated that the underlying agreement required payment at the increased post-default interest rate to cure and the applicable state law permitted payment at such interest rate.
- The Ninth Circuit further supported its conclusion by pointing to the House Report for the bill that became Bankruptcy Code section 1123(d), which indicated that the provision is meant to "limit the secured creditor to the benefit of the initial bargain with no court contrived windfall" and to put the debtor "in the same position as if the default had never occurred."

Thank you to our
panelists and audience!

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