AMERICAN BANKRUPTCY INSTITUTE

2017 Winter Leadership Conference

Confirming a Chapter 11 Case: How to Get to the Finish Line

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U.S. Bankruptcy Court (S.D.N.Y.); White Plains

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CONCURRENT SESSION

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CLEARY GOTTLIEB

Confirmation: How to Get to the Finish Line

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Panelists

— **James L. Bromley,** ***Moderator***
- Cleary Gottlieb Steen & Hamilton LLP, New York, NY

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Topics for Discussion

—Lynchpin Litigation and Mediators on the Road to Confirmation

—Avoiding Chapter 22: Satisfying the 1129(a)(11) Feasibility Test

"Lynchpin Litigation" and Mediators on the Road to Confirmation

Lynchpin Litigation

— Lynchpin litigation is litigation that tees up a critical issue for resolution as part of or in conjunction with confirmation
  - Enormous pressure on parties to settle
  - Enormous pressure on courts to expedite litigation to facilitate confirmation

— Several recent cases illustrate the importance of addressing key litigation in connection with confirming a proposed plan:

— Critical litigation that can derail or delay a bankruptcy case includes:
  - Resolution of a major disputed claim (e.g., PBGC claims) – *Nortel*
  - Resolution of avoidance actions – *SunEdison*
  - Resolution of environmental, tax or other regulatory claims – *Lyondell*

Enter the Sandman (Mediator)

—Increasing use of mediators in lynchpin litigation (*Sun Edison, Avaya*)
  - Often the mediator is another sitting judge in the District

—Potential Benefits of Mediation
  - Unbiased view of litigation risk/reward
  - Credibility with all parties
  - Strong personality preferred

The Role of A Mediator

Several recent cases demonstrate the value of a mediator in getting a contested plan through confirmation:

— *In re Residential Capital LLC*, No. 12-12020 (MG) (Bankr.S.D.N.Y.)

- Judge Peck mediation was successful in negotiating $2.1 billion Ally Financial settlement.

— *In re Cengage Learning Inc*., No. 13-44106 (ESS) (Bankr.E.D.N.Y.)

- Judge Drain successfully mediated a plan that resolved hold-up issues and ultimately resulted in a plan providing second lien and general unsecured creditors with an increased recovery.

— *In re SunEdison, Inc*., No. 16-10992 (SMB) (Bankr.S.D.N.Y.)

- Judge Morris appointed as mediator by Judge Bernstein in April, 2017; successfully mediates multiple plan objections, including avoidance action allocation dispute, resulting in confirmed plan in July of 2017.

Mediator v. Accelerated Litigation

—Need it be a choice or can both be pursued?

—Does likelihood of mediator appointment encourage extreme positions in pre-mediation negotiations?

—How feasible is accelerated litigation?

- Complexity of issues
- Timing for document discovery, depositions, experts, potential motions and trial
- Due process concerns

Lynchpin Litigation Case Study: PBGC Claims in *Nortel* (No Mediator/Accelerated Litigation)

—**Issue**: Size of PBGC unfunded benefit claim

- Delta of up to $400 million
- Legal issues and factual issues
- Relatively limited document discovery
- Few fact witnesses
- 3 month compressed time frame

—**Result**: Settlement of ~$150 million

Lynchpin Litigation Case Study: *SunEdison, Inc.* (Mediator: Hon. Cecelia G. Morris)

—**Issue**: Allocation dispute between Debtors, UCC and secured lenders regarding allocation of proceeds of proposed sale of YieldCos

- Debtor proposed resolution of potential avoidance claims with $16.1 million settlement payment for UCC

—**Result**: Global settlement reached

- Avoidance claim settlement increased from $16.1 to 18.0 million
- Second lien creditors received all equity in new SunEdison
- $5 million in professional fees given up by all mediation members for allocation to UCC

Lynchpin Litigation Case Study: *Avaya Inc.* (Mediator: Hon. Cecelia G. Morris)

— **Issue**: Multiple objections to plan from second lien debt and UCC to proposed plan giving first lien debt

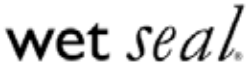
- Debtors opposed mediation
- Second lien and crossover group objected to proposed plan as a contrived plan between debtors and first lien group to shift value to first liens
- Additional objections to alleged insider dealings with directors and officers
- Objection to proposed PBGC recovery of approximately 40% relative to second lien recovery of less than 2%

— **Result**: To be determined

- Confirmation hearing scheduled for November 15, 2017

Avoiding Chapter 22: Satisfying the 1129(a)(11) Feasibility Test

The Chapter 22 Case – Returning to Chapter 11 After a "Feasible" Plan Fails



The Chapter 22 Case – Returning to Chapter 11 After a "Feasible" Plan Fails

Debtor	Ch. 11 Filing Date	Ch. 22 Filing Date	Elapsed Time Between Filings
RadioShack Corp.	February 5, 2015	March 8, 2017	~25 months
The Wet Seal, LLC	January 16, 2015	February 2, 2017	~25 months
American Apparel, Inc.	October 5, 2015	November 14, 2016	~13 months
Global Geophysical Services, Inc.	March 26, 2014	August 3, 2016	~28 months
Hercules Offshore, Inc.	August 13, 2015	June 6, 2016	~10 months
Great Atlantic & Pacific Tea, Inc. (A&P)	December 13, 2010	July 19, 2015	~55 months

The 1129(a)(11) Feasibility Test

— Section 1129(a)(11) of the Bankruptcy Code provides that a plan may only be confirmed if:

> Confirmation of the plan is not likely to be followed by the 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. 11 U.S.C. § 1129(a)(11)

— Although courts have made clear that ensuring the debtor's "[g]uaranteed success in the stiff winds of commerce" is not the standard required by the 1129(a)(11) feasibility test, courts do require some evidence that a proposed plan is "reasonably likely to succeed on its own terms" and that it provides for a "realistic and workable framework." *In re Prudential Energy Co.*, 58 B.R. 857, 862 (Bankr.S.D.N.Y. 1986); *In re Am. Capital Equip., LLC*, 688 F.3d 145, 156 (3d Cir. 2012) (internal citations omitted).

The 1129(a)(11) Feasibility Test: Factors

— In making the 1129(a)(11) feasibility determination, courts have looked to the following factors:

- The adequacy of the debtor's capital structure under the proposed plan;
- The earning power of the debtor's business;
- The external economic conditions;
- The ability of the Debtor's management;
- The probability of the continuation of the debtor's management;
- The potential impact of any current litigation involving the debtor on the feasibility of the proposed plan.

See In re Greate Bay Hotel & Casino, Inc. 251 B.R. 213, 226 (Bankr.D.N.J. 2000); *Sherman v. Harbin (In re Harbin)*, 486 F.3d 510, 519 (9th Cir. 2007).

Evidentiary Requirements for Feasibility

Findings of Fact as to Each Feasibility Factor Supported by:

— Financial Advisors
- Adequacy of the reorganized entity's proposed capital structure
  - Debt-to-equity ratio
  - Cash flow positive
- Earning power of the business – how is the company likely to perform?
  - Assumptions: sales, costs of inputs, competition in the reorganized entity's market.
- External economic conditions likely to face the reorganized debtor.

— Stakeholders
- Ability of management and probability of continuation

— Debtor
- Impact of litigation

Is There a Duty to Prevent Chapter 22 Cases?

— What is the Court's duty–if any–if no party objects, but the Court has concerns regarding feasibility?
- The debtor has the burden of proof in establishing that 1129(a)(11) is satisfied and will provide expert testimony regarding feasibility if there is an objection on feasibility grounds. *See, e.g., In re Paragon Offshore PLC*, No. 16-10386 (CSS), 2016 WL 6699318 (Bankr.D.Del. Nov. 15, 2016) (rejecting proposed plan on feasibility grounds after considering expert testimony provided by debtor).
- However, in the absence of an objection to feasibility, the debtor may simply assert that the plan is feasible and the court must determine (in the absence of expert testimony) whether the plan is feasible.
- A court has an independent duty to determine feasibility, even in the absence of an objection to the proposed plan. *In re Las Vegas Monorail Co.*, 462 B.R. 795, 798 (Bankr.D.Nev. 2011)
  - Does the court have an independent duty to consult experts regarding feasibility?
  - Should the court rule on feasibility without any expert testimony?

Causes of Chapter 22 Cases

—Overly optimistic business plans

- Failure to address structural business flaws during Chapter 11 case

—Unwillingness to de-leverage sufficiently to avoid a new crisis

- What is the bare minimum necessary to scrape by?
- "Exit and Trade" vs. "Loan to Own"

—Focus of financial creditors on trading out of reorganized company

- Little incentive to protect the business's long term prospects

Damage Caused by Chapter 22 Cases

— Non-financial creditors tend to suffer more

- Employees
- Retirees
- Trade creditors, especially local trade
- Hometowns of "reorganized" business

— Insufficiently capitalized firms that seek chapter 22 protection are more likely to liquidate

- Wet Seal
- Hercules Offshore
- A&P

1129(a)(11) Recent Cases: *Paragon Offshore*

— The most recent case to extensively explore the scope of the 1129(a)(11) feasibility requirement was *In re Paragon Offshore PLC*, No. 16-10386 (CSS), 2016 WL 6699318 (Bankr.D.Del. Nov. 15, 2016).

— In Paragon, the court rejected a plan proposed by the debtor, finding that liquidity was the key consideration and the proposed plan provided insufficient liquidity for the debtor to have a reasonable likelihood of successfully reorganizing without revisiting chapter 11.

— The court also looked to the maturity of the debtor's debt and found that the debtor would be unlikely to be able to refinance its debt at maturity (in 2021), given the current and projected economic conditions in the intervening years.

  • Although courts do not have a consistent approach to how far in the future the feasibility inquiry should extend, the *Paragon* court did not hesitate to consider the likelihood (or lack thereof) of repayment of debt maturities 5 years down the road.

— The court also found that balance sheet insolvency upon emergence from bankruptcy is not dispositive of feasibility, although it is one of several relevant factors to consider.

  • Although parties often litigate balance sheet insolvency, a formal solvency analysis alone is not itself sufficient to satisfy 1129(a)(11) in the Delaware bankruptcy courts.

1129(a)(11) Recent Cases: In re Las Vegas Monorail Co.

— In re *Las Vegas Monorail Co*., 462 B.R. 795 (Bankr.D.Nev. 2011) involved a plan proposed by the Las Vegas Monorail company that provided for annual debt payments with a balloon payment of approximately $30 million due after 7 years.

— No party objected to the plan and the debtor submitted testimony from an outside expert stating that the plan was feasible.

— The court, however, determined that the plan was not feasible because the projections did not provide for a reasonable likelihood that the balloon payment could be satisfied in 7 years, even if the annual payments were likely to be satisfied under the plan.

— The court ultimately thought the proposed plan was simply too speculative and rejected confirmation:

> *While poor planning undertaken by prior management may have contributed to LVMC's economic woes, LVMC has never shown the ability to service the massive debt incurred in its construction. On top of this wobbly base, the current economic situation simply threw gas on an existing fire—it worsened, rather than created, LVMC's problems. Nonetheless, LVMC now asks the court to trust that it will do, over the next several years, that which it has been unable to do since its inception. LVMC's embrace of these multiple speculative future events to establish feasibility underscores its questionable strategy.*

In re Las Vegas Monorail Co., 462 B.R. 795, 802 (Bankr.D.Nev. 2011)