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The Role of Governmental Agencies in Chapter 11 Cases

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The Role of Governmental Agencies in Chapter 11 Cases

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Overview of the Role of the SEC in Bankruptcy Proceedings

A. History of the interplay between bankruptcy and SEC dates back to the formation of SEC

1. Chandler Act, Ch. 575, §§ 161, 208, 52 Stat. 840, 889, 894 (1938).

"Sec. 161. The judge shall fix a time of hearing, to be held not less than thirty days and not more than sixty days after the approval of the petition, of which hearing at least thirty days' notice shall be given by mail to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission and such other persons as the judge may designate, and, if directed by the judge, by publication in such newspaper or newspapers of general circulation as the judge may designate.

"Sec. 173. The judge shall not enter an order approving a plan submitted to the Securities and Exchange Commission until after the Securities and Exchange Commission has filed its report thereon or has notified the judge that it will not file a report, or until the expiration of such reasonable time for the filing of such report as the judge has fixed whichever first occurs.

"SEC. 208. The Securities and Exchange Commission shall, if requested by the judge, and may, upon its own motion if approved by the judge, file a notice of its appearance in a proceeding under this chapter. Upon the filing of such a notice, the Commission shall be deemed to be a party in interest, with the right to be heard on all matters arising in such proceeding, and shall be deemed to have intervened in respect of all matters in such proceeding with the same force and effect as if a petition for that purpose had been allowed by the judge; but the Commission may not appeal or file any petition for appeal in any such proceeding.

2. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified through Title 11, U.S.C.) repealed the Bankruptcy Act of 1898 and its amendments such as the Chandler Act. It removed the requirement for the SEC to report on reorganization plans. But preserves the right of the SEC to appear and raise issues in Chapter 11 proceedings. *See* 11 U.S.C. § 1109.

B. Potential for tension between the goals of the SEC and the objectives of bankruptcy:

1. Primary goals of bankruptcy are (a) in Chapter 7 quick and efficient liquidation designed to maximize returns to all creditors, and (b) in Chapter 11 workout situation relieve some pressure on company to provide opportunity to re-emerge as a viable enterprise

2. Mandate of SEC, on the other hand is to protect investors, maintain orderly markets, and promote capital formation

3. Only one of these is implicated by bankruptcy filings, the protection of investors

4. While bankruptcy process attempts to address the overall financial dynamics of the distressed enterprise, the SEC's single-minded efforts at getting returns for a sub-class of the company's many creditors, the shareholders, may put it at odds with other legitimate stakeholders

a. "The SEC must still enforce securities law violations, but parties in interest in the bankruptcy case have concerns that may conflict with the SEC's position. . . . [A] bankruptcy case is a complex interaction between a number of parties, all fighting for the same very limited assets, under the supervision of a bankruptcy judge and the U.S. Trustee. The SEC may want to bring an enforcement action that would result in a payment of the debtor's assets to the SEC, and that may cause other constituents with claims against the debtor's assets to object." Kelli A. Alces, *Limited the SEC's Role in Bankruptcy*, 18 AM. BANKR. INST. L. REV. 631, 634 (2010).

C. Bankruptcy Code allows expressly for participation by SEC:

1. Section 362(b)(4) of the Bankruptcy Code exempts from the automatic stay actions brought by governmental units to enforce their police and regulatory power and judgments . . . obtained in such enforcement proceedings. 11 U.S.C. § 362(b)(4) (2006)

2. However, § 362 expressly carves out "monetary judgments"

D. Despite the statutory authority, the SEC has traditionally defined its role as "limited":

1. "In most bankruptcy cases, the role of the SEC is limited. The SEC will review the company's disclosures to determine if the company is telling investors and creditors the important information they need to know, and to ensure that stockholders." *See, e.g.*, Fast Answers: Bankruptcy at https://www.sec.gov/fast-answers/answers-bankruphtm.html

2. See, e.g., SEC's "Agency Financial Report Fiscal Year 2017, https://www.sec.gov/files/sec-2017-agency-financial-report.pdf (under "Performance Highlights" no mention of the bankruptcy program)

3. SEC also has apparently discontinued practice of listing matters it was monitoring. This may suggest a diminished role for SEC as well. https://www.sec.gov/open/datasets-bankruptcy.html

4. A more detailed self-description of its role is elsewhere on its website: there, in addition to the review of company disclosures, the SEC undertakes to "ensure that stockholders are represented by an official committee, if appropriate." The SEC goes on to say that although it "does not negotiate the terms of reorganization plans, [it] may take a position on important legal issues that will affect the rights of public investors in other bankruptcy cases as well. For example the SEC may step in if [it] believe[s] that the company's officers and directors are using the bankruptcy laws to shield themselves from

lawsuits for securities fraud." *See* https://www.sec.gov/reportspubs/investor-publications/investorpubsbankrupthtm.html

E. In practice, the SEC's level of involvement has varied greatly from case to case (although the reported decisions may give a skewed view as they by definition involve matters in which the SEC was most involved):

1. Enron bankruptcy

The SEC was an active participant in the Enron case. The agency objected to the retention of various officers, and insisted on revised mandates for some of those kept on. For example, the SEC objected to the employment of the former CEO, who was promised a $5 million success fee and given the ability to negotiate a plan with current and former clients and investors, but had no clearly articulated fiduciary duty to the estate. The contract was restructured to add express fiduciary duties and responsibilities.

The SEC also successfully objected to a proposed employee retention program which provided for bonuses of about $130 million and would have waived preference claims against them, and joined in a successful creditors' motion for the appointment of an examiner, helped locate an appropriate candidate, and helped craft the order of appointment describing the scope of his duties.

On the other hand, the SEC appeared to overreach when it tried to keep from the creditors' committee the $8 million it secured in a settlement with a former executive. The creditors' committee sued, asked that jurisdiction be given to the bankruptcy court, and argued that the money, since it was stolen from Enron, should be repaid to the estate and distributed with other assets according to the Bankruptcy Code. The SEC argued that the matter should be heard by the district court. The matter was settled and Enron's defrauded bondholders were permitted to make claims against the settlement funds.

The SEC stayed active throughout the pending proceedings, including evaluating the structure of proposed third party settlements. In the end, the SEC ultimately withdrew its proof of claim in bankruptcy because Enron was liquidated and the SEC had already collected hundreds of millions of dollars in its enforcement cases against financial institutions that were, allegedly, part of Enron's fraud.

Source: Alistaire Bambach & Samuel R. Maizel, *The SEC's Role in Public Company Bankruptcy Cases Where There Is a Significant Enforcement Interest*, 2005 ANN. SURV. BANKR. L. 99, 111-12.

2. WorldCom bankruptcy

The WorldCom bankruptcy resulted from one of the largest accounting fraud cases in American history and provides an example of particularly aggressive SEC involvement. WorldCom made somewhere between $10 and $17 billion due to the fraud and losses to shareholders were more than $200 billion. The fraud also spawned class action suits, criminal cases against former officers and directors, and an enforcement action brought by the SEC.

The SEC in its case moved for the appointment of a corporate monitor, whose mandate provided for veto power over extraordinary corporate expenditures. In addition to the monitor, the SEC reviewed WorldCom's financial condition throughout the case, evaluated creditor recoveries, assessed potential recoveries from third parties, analyzed WorldCom's business plan for ongoing operations, and reviewed sources of available funding to pay for an SEC claim. The SEC ultimately settled its claim in the case for $500 million in cash plus $250 million in stock in the reorganized company. The SEC was also able to structure a plan for victim compensation. The settlement was approved by both the bankruptcy and district courts.

In determining an appropriate compromise of its penalty claim the SEC considered the government's power to compel the liquidation of the company but ultimately rejected the urging of its competitors to do so. The SEC concluded that WorldCom had made progress in its efforts to change its corporate culture and dismiss wrongdoers and that causing the liquidation of the company, which would adversely impact some 50,000 employees and thousands of investors, was not a beneficial outcome.

The SEC also actively participated in WorldCom's reorganization plan, reviewing objections by creditors to consolidation of the company's assets and liabilities and assessing the impact on the SEC settlement. In the end, the SEC supported a plan that that ensured adequate funding for the SEC settlement and left WorldCom sufficient money to reorganize.

Source: Bambach & Maizel at 112-13.

3. Adelphia Communications Corporation

Adelphia filed for Chapter 11 bankruptcy in 2002 after revelations of liabilities of $2 billion that had not been reflected on its financial statements and other irregularities. The DOJ indicted several individuals and threatened to indict the corporation. The SEC filed civil enforcement actions against Adelphia and other parties, and thereafter filed a proof of claim in the bankruptcy case for disgorgement, interest and penalties, potentially amounting to several billions of dollars. Absent a settlement, the SEC said it would pursue the full amount.

The creditors' committee filed an adversary proceeding to determine the priority of the SEC's claim, arguing that creditors' claims were senior to any shareholder claims that would be vindicated by the SEC's enforcement action.

With the leverage provided by threats of a possible criminal indictment and an SEC enforcement action, DOJ joined with the SEC in a $1 billion demand to resolve their respective actions. Extensive negotiations ensued, with the government relying on the specter, among other things of indictment and forfeiture, while Adelphia contended that the amount was out of line with the WorldCom resolution. Finally, after weighing the risks, Adelphia upped its offer resulting in a reduced demand from the government of $725 million that Adelphia accepted, ultimately reduced further to $715 million in the final package.

During the settlement negotiations, the creditors' committee took the position with Adelphia's board that any settlement could only be funded with value that otherwise would be provided to holders of bank claims. The committee threatened to object to any settlement structured otherwise. Eventually the committee was cut out of the loop on the settlement negotiations by the government, which informed Adelphia that if the settlement terms were shared with the committee, the deal was off.

The settlement was approved by the bankruptcy court. The court rejected the creditors' claims that the settlement breached the board's fiduciary duties and also rejected the premise that use of the settlement to compensate equity shareholder violated federal bankruptcy law. The court noted the uncertainty of whether the SEC's proof of claim would have been allowed, but concluded that such uncertainty militated in favor of approving a settlement for much less than the total potential liability.

In re Adelphia Communications Corp., 327 B.R. 143 (Bankr. S.D.N.Y 2005).

4. First Jersey/Brennan

The SEC appeared to overreach in the First Jersey matter, a case involving a broker-dealer securities fraud case in New Jersey. The SEC obtained a disgorgement judgment against Brennan for $75 million plus interest. Brennan then filed for Chapter 11 bankruptcy protection. But before the judgment and Chapter 11 petition, Brennan established an offshore trust. Brennan initially did not disclose the trust on his bankruptcy petition, but later disclosed albeit indicating he had no financial interest in it.

Initially, both the bankruptcy court and foreign court rejected SEC-blessed attempts to repatriate the trust assets. The SEC claimed that it was not attempting to collect the judgment, which would run afoul of the automatic stay provisions of the Bankruptcy Code. Instead it said it was merely trying to protect the assets. Eventually the district court entered an order requiring Brennan to repatriate the assets and to show cause why he should not be held in contempt of the disgorgement judgment.

Brennan appealed to the Second Circuit, which agreed that the district court's order violated the automatic stay provisions of 11 U.S.C. § 362(a). The appellate court concluded that order regarding the collection of assets after entry of a judgment fall within the "exception to the exception" that exempts police and regulatory actions from the automatic stay but prohibits collection of money judgments as part of those actions. The court rejected the SEC's arguments that it was merely trying to preserve assets because the SEC obtained the repatriation order in order to eventually satisfy the judgment using procedural mechanisms for enforcing judgments. The court noted, however, that its decision did not affect the bankruptcy court's power to order repatriation of the assets as part of the bankruptcy estate.

SEC v. Brennan, 230 F.3d 65 (2d Cir. 2000).

5. Woodbridge Group of Companies.

Following the commencement of its Chapter 11 case, the U.S. Securities and Exchange Commission sued Woodbridge Group of Companies for allegedly operating a $1.2 billion Ponzi scheme targeting thousands of investors, sought a post-petition asset freeze and receiver, and brought a motion in the bankruptcy case seeking to cause the appointment of a Chapter 11 Trustee.

According to the SEC's complaint, Woodbridge ran a "sham" business model that allegedly defrauded more than 8,400 investors in unregistered Woodbridge funds. Woodbridge operated under new management post-petition and was actively taking steps to preserve investor value. A creditors committee was appointed in the case and was actively negotiating with the Debtors seeking to resolve concerns regarding the operation of the case. Ultimately a settlement we reached in which new management was appointed to administer estate assets.

(*In re Woodbridge Group of Companies, LLC* (17-12560 (KJC) Bankr. Del 2017).

6. There are many cases in which the SEC takes a more passive monitoring role that do not result in published decisions.

In re EV Energy Partners, L.P. (1:2018-bk-10814 Bankr. Del. 2018). SEC objected to the plan and disclosure statement to address release and exculpation provisions in order to protect the interests of investors, who were concerned about alleged omissions from the debtors' SEC filings, related-party transactions and insider trading activities, "which could form the basis of claims by the investors against the non-debtor parties being released."

F. What is the optimal role for the SEC?

1. Some commentators have argued for a smaller role in bankruptcy matters based on expertise. "[A] chapter 11 trustee can become intimately acquainted with all aspects of a company and has the bankruptcy experience to guide the company through the reorganization." *See* Alces, *supra*, at 644 (arguing further that "[b]efore the SEC decides to bring an enforcement action against a bankrupt company . . . it should determine whether SEC action is really necessary, that is, whether its purpose is advanced by interceding.")

"The federal receiver, therefore, becomes a liquidator without the supporting structure of the Bankruptcy Code, Rules, and precedent. The procedure for liquidation becomes ad hoc, employing "equity" as the only guideline. As we know, not all parties agree as to what constitutes equitable treatment. The creeping receivership and late liquidating decision cause unpredictable, disorganized and haphazard receivership liquidations with procedures constricted and developed only as needed at the potential expense of creditors or other parties. By contrast, the Bankruptcy Code provides a complete, coordinated and integrated mechanism for orderly liquidation." *See* Marcus F. Salitore, *SEC Receivers vs. Bankruptcy Trustees: Liquidation by Instinct or Rule*, AM. BANKR. INST. J., Oct. 2003, at 8.

2. On a related note, the view is also advanced that SEC scarce resources can be better deployed searching for the next fraud rather than immersing itself in a situation in which "the damage to the market and investors in the firm has already been done." Alces, *supra*, at 637. *See also* Jonathan R. Macey, The Distorting Incentives Facing the U.S. Securities and Exchange Commission, 33 HARV. J.L. & PUB. POL'Y 639 (2010), cited by Alces.

3. Severe criminal sanctions for violating bankruptcy procedures:

18 U.S.C. § 157 is the catch-all bankruptcy fraud provision, making it a crime to file a bankruptcy petition or any document in a pending bankruptcy in connection with a "scheme or artifice to defraud."

Title 18, United States Code, Chapter 9 contains a number of bankruptcy crimes:

- § 152 – Concealment of assets; false oaths and claims; bribery
- § 153 – Embezzlement against estate
- § 154 – Adverse interest and conduct of officers
- § 155 – Fee agreements
- § 156 – Knowing disregard of bankruptcy law
- § 157 – Bankruptcy fraud
- Also: 18 U.S.C. § 1519 – obstruction of title 11 proceedings

By statute, "any judge, receiver, or trustee . . . shall report to the appropriate United States attorney" instances of bankruptcy crimes. 18 U.S.C. § 3057.
Each U.S. Trustee shall notify the appropriate U.S. Attorney of bankruptcy crimes, and upon request, assist[] the United States attorney in carrying out prosecutions based on such action upon request)(3)(F).

4. Given the level of supervision and deterrence inherent in the system along with the resource issues facing the SEC, there is an argument to be made for a limited and carefully circumscribed involvement of the SEC post-bankruptcy petition.

Intro to PBGC

Pension Benefit Guaranty Corporation

Overview of PBGC

- Title IV of the Employee Retirement Income and Security Act of 1974 ("ERISA") created the Pension Benefit Guaranty Corporation ("PBGC")
- PBGC is a wholly-owned government corporation and the federal agency charged with administering the termination insurance program under Title IV of ERISA
- The Corporation is governed by a Board of Directors comprised of the Secretaries of Labor (chair), Treasury and Commerce. Daily operations are overseen by the Director who is nominated by the President with the advice and consent of the Senate. The Director serves a 5-year term at the pleasure of the President and the Board.
- PBGC's Mission (per statute)
  - Encourage the continuation and maintenance of voluntary private pension plans
  - Provide for timely and uninterrupted payment of pension benefits to participants and beneficiaries
  - Maintain premiums at the lowest level consistent with its obligations

2

Pension Benefit Guaranty Corporation

Two Types of DB plans

- PBGC maintains two separate insurance programs: a single-employer program and a multiemployer program
- Multiemployer Plans
  - Collectively bargained and sponsored by more than one employer
  - Administered by Board of Trustees
  - Facilitates continued benefit accruals when employee moves from employer to employer (but sticks with union)
- Single-employer Plans
  - One employer sponsors the plan on behalf of its employees
  - May or may not be collectively bargained
  - ***Today's discussion focuses on single-employer pension plans***

3

Pension Benefit Guaranty Corporation

PBGC's Attempts to Mitigate Risk Before Insolvency

- Outside of bankruptcy, PBGC monitors the financial health of plan sponsors with pension plans that pose a greater risk to the agency and the pension insurance system under its Risk Mitigation and Early Warning Program
- For plan sponsors in financial distress, PBGC will engage the plan sponsor in discussions about protections for the pension plan ahead of any bankruptcy or insolvency proceeding

4

Pension Benefit Guaranty Corporation

PBGC'S Role In Bankruptcy

When Plan Sponsors File - PBGC's Appointment to Creditors' Committees

- PBGC has been appointed to serve on unsecured creditors' committees for the past several decades
- PBGC acts as a contingent creditor on behalf of the Debtor's pension plan
- PBGC officials have extensive experience as members of committees and bring a high level of sophistication and knowledge to discussion of outcomes to benefit all unsecured creditors

6

Pension Benefit Guaranty Corporation

When Plan Sponsors File - PBGC's Powers in Bankruptcy

- Each member of a plan sponsor's Controlled Group ("CG") is jointly and severally liable for claims arising from plan termination
  - Generally, a CG exists when there is a parent business which owns 80% or more of a subsidiary business.
  - See IRC section 1563(a)(1) and Treas. Reg. Section 1.414(c)-2(b)
- Plan sponsors who fail to make required minimum funding contributions greater than $1mm during the pendency of the bankruptcy may be subject to statutory liens arising under IRC section 430(k)
- PBGC can perfect liens on assets of CG members who have not sought bankruptcy protection (where automatic stay doesn't apply)

7

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Alternatives When Filing

PBGC

When Plan Sponsors File -
Plan Sponsor Assumes Plan Post-Reorganization

- In many cases, the Plan of Reorganization provides that the pension plan will be assumed and maintained by the reorganized entity.

- Recent examples:
  - Alpha Natural Resources
  - Exide
  - American Airlines

- Plan sponsors make this decision for a number of possible reasons:
  - Continuing the plan may be a tool to retain valued employees
  - Terminating the plan triggers liabilities which significantly reduce recoveries to other unsecured creditors
  - Maintaining the plan may be required by a collective bargaining agreement
  - Terminating the plan may be difficult if the post-reorganization business plan shows the plan to be affordable

9

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When Plan Sponsors File -
Plan Sponsor Decides to Pursue Termination of the Plan

- In certain situations, the plan sponsor seeks termination of the Plan

- Plan sponsors make the decision to terminate for a number of possible reasons:
  - Debtor seeks sale of certain or substantially all of the Debtor's assets free and clear of all liens and encumbrances
  - Debtor makes compelling case to the bankruptcy court that the reorganized Debtor cannot afford to maintain its pension plan as part of a successful reorganization

10

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Single-employer Plan Terminations

PBGC

Types of Single-Employer Plan Terminations in Bankruptcy

PBGC-Initiated	Distress

- Should the plan sponsor seek to sell all or substantially all of its assets leaving little or no assets within the Controlled Group to support the pension plan, PBGC may initiate plan termination
- Recent examples:
  - M&G USA Corporation
  - Walter Energy
  - Standard Register
- A plan sponsor may seek plan termination in bankruptcy by filing a motion for approval of a distress termination
  - The plan sponsor must demonstrate that the pension plan is unaffordable
  - PBGC may object if it has concluded that the pension plan appears to be affordable based on the Debtor's business plan
  - If the bankruptcy court approves the plan sponsor's request for a distress termination, PBGC must still undertake its process to terminate and trustee the plan.
  - ***As part of this process, the plan sponsor must demonstrate that no member of the plan sponsor's CG can afford the pension plan (on a plan by plan basis)***
- Recent examples:
  - Avaya, Inc. (Avaya sought a distress termination of one of its two pension plans)

12

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Plan Termination - Effect of Terminating The Plan

- The bulk of PBGC's claims are typically general unsecured claims and are often the largest unsecured claims. These claims include:
  - Unfunded benefit liabilities (Liabilities less market value of assets)
  - Due and unpaid employer contributions
  - Annual Premiums (Flat and Variable rate)
  - ***Termination Premiums***
- The termination premium obligation arises upon the termination of the bankruptcy itself
  - Termination premiums are not dischargeable
  - Termination premiums are payable in three annual installments post-emergence

13

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Fulfillment of Liability to PBGC

PBGC

Employer/Sponsor Liability

- Sponsor is liable to PBGC for:
  - Unfunded benefit liabilities (plan liabilities at termination less plan assets – often the largest unsecured claim in bankruptcy)
  - Unpaid contributions
  - Unpaid PBGC premiums
- Based upon the capital and organizational structure of the sponsor, PBGC negotiates commercially reasonable resolution of the sponsor's liabilities
  - PBGC has worked with hundreds of plan sponsors to structure resolutions to pension plan liabilities arising from the termination in bankruptcy of covered pension plans
  - Recent example: Avaya
- If the plan sponsor and PBGC cannot come to an agreement on resolving the liabilities, PBGC will take all steps within its power to collect those liabilities
  - PBGC will seek to enforce its claims in bankruptcy
  - PBGC will make a demand for payment from CG members outside of bankruptcy
  - If non-Debtor CG members fail to pay, then a lien arises in favor of PBGC as of the termination date of the plan
  - The amount of the lien is limited to 30% of the collective net worth of these non-Debtor CG members

15

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