What's Wrong with Chapter 11?

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What's Wrong with Chapter 11: Hedge Fund and Private Equity Funds' Control of the Chapter 11 Process

American Bankruptcy Institute
Views From the Bench 2016

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Introduction

- In recent years, private equity firms and hedge funds have become increasingly frequent figures in high-profile Chapter 11 cases
- Commentators have speculated that the involvement of private equity firms and hedge funds has led to an increased emphasis on the pre-bankruptcy stage of a restructuring
- Pre-bankruptcy negotiations can be outcome-determinative of a case and occur without the oversight of the Bankruptcy Court, the United States Trustee or any statutory committee

Questions presented

- Do private equity firms and hedge funds control the Chapter 11 process, and if so, how?
- Are pre-bankruptcy agreements effective?
- Do pre-bankruptcy agreements subvert the Chapter 11 process or make it more efficient?
- Are legislative reforms likely to alter investment behavior or the trend toward “prearrangements”?

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Private Equity

- A private equity firm, often referred to as a sponsor, is an investment manager that purchases significant equity positions in operating companies
- Private equity firms typically raise capital through external sources (usually limited partnerships), including pension and retirement funds, insurance companies, high net worth individuals and endowment
- Firms charge investors management fees and collect a percentage of profits
- Firms often purchase equity through a leveraged buyout and seek to exit investments in 3-7 years

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Hedge funds

- A hedge fund is an investment manager that pools capital from accredited individuals and institutional investors and invests in alternative investments, including derivatives
- Hedge funds often employ a long/short strategy and use sophisticated investment techniques, such as arbitrage and hedging
- Some hedge funds' strategy includes purchasing distressed bonds in anticipation of increasing recovery in an anticipated Chapter 11
- Fulcrum security is often, but not always, the focus

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Regulation of private equity and hedge funds

- Before 2012, private equity firms and hedge funds were for the most part unregulated
- Since the enactment of the Dodd-Frank Act, most private equity and hedge funds are required to register as investment advisors and are subject to reporting requirements with the Security and Exchange Commission

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Private equity vs. hedge funds

- Some private equity funds sponsor buyouts through Chapter 11, increasing their return when private equity ultimately divests the investment
- Unlike hedge funds, private equity funds do not typically acquire distressed debt, but will more typically look at acquiring a controlling equity stake in a target company

Utilization of Chapter 11 – private equity sponsored plans

- One typical strategy is for a private equity firm to negotiate with a distressed company’s management to exchange the reorganized company’s controlling equity in exchange for a cash infusion
- A private equity sponsored Chapter 11 plan will often eliminate the existing debt securities in exchange for the issuance of new debt securities on restructured terms or a minority equity share, or in some instances, contingent value rights (warrants, options, etc.)

Utilization of Chapter 11, continued

- A hedge fund may look to control a Chapter 11 process by acquiring the fulcrum security
- In the case of either a private equity sponsored plan or a pre-arranged plan negotiated with hedge funds holding debt securities, agreements are often negotiated in advance of a bankruptcy filing and implemented through a prearranged Chapter 11 plan

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Private equity plan sponsorship or hedge fund prearranged plans

- The distressed company will enter into a restructuring support agreement ("RSA") whereby it will agree to pursue confirmation of the plan under certain prenegotiated terms
- Parties to an RSA have involvement (if not veto power) over most major decisions in the case
- Creditors who are disadvantaged or disenfranchised by such an arrangement will usually contest the plan through litigation

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Typical Aspects of a prearranged Chapter 11

- An RSA or plan support agreement ("PSA") which provides that the agreement will terminate if deadlines for certain approvals are not met
  - These usually include approval of the RSA/PSA, disclosure statement and plan
- A "fiduciary out" that excuses the debtor's obligations under the RSA/PSA if its fiduciary duties require otherwise

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RSAs: the new normal?

- Have plan sponsors or fulcrum security holders supplanted the decision-making of the Bankruptcy Courts? Do RSAs or PSAs tie the Courts' hands?
- Do RSAs advance the process by streamlining the process and facilitating a faster exit from Chapter 11? Or do they simply lead to a longer and more expensive process because of the inevitable objections from non-parties to the RSA?

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Our market has changed. Roles that have historically been dominated by banks and other traditional financial institutions have morphed into a world where private equity firms and hedge funds are playing the roles traditionally ascribed to senior secured creditors. In some cases, hedge funds also play the role of subordinated bondholders.

This presentation highlights issues likely to arise when private equity firms and hedge funds play a prominent role in the chapter 11 process. While no one panel discussion can address all likely issues to arise in chapter 11 for key economics players such as private equity firms and hedge funds, the panel on "What's Wrong with Chapter 11?" will begin the discussion and hopefully highlight the need for certain remedial measures.

To facilitate this discussion, the panelists have prepared two sets of materials. The first set of materials includes summaries of recent decisions that, among other things, examine (i) the applicability of the "safe harbor" protection of section 546(e) of the Bankruptcy Code, (ii) whether the safe harbor provision preempts certain state law fraudulent transfer claims, and (iii) certain rights and obligations of private equity firms in the chapter 11 process. The second set of materials is a PowerPoint presentation that highlights the key questions and recent developments that will guide today's discussion. We hope that these materials are helpful both during today's presentation and in the future.

Case Summaries:

***FTI Consulting, Inc. v. Merit Management Group, LP*, No. 15-3388, --F.3d --, 2016 WL 4036408 (7th Cir. July 28, 2016)**

Background Facts:

Valley View Downs, LP ("Valley View" or the "Debtor"), a racetrack operator in Pennsylvania, acquired its competitor Bedford Downs for $55 million prior to the petition date. Valley View borrowed the purchase amount from Credit Suisse, which disbursed the funds in accordance with the credit agreement and purchase escrow agreement to Citizens Bank, as the escrow agent. Citizens Bank held the transfers in escrow pursuant to the terms of the escrow agreement until the transaction closed and then, in relevant part, distributed approximately $16.5 million to defendant Merit Management Group, LP ("Merit") as a 30% owner of Bedford Downs. *See FTI Consulting, Inc. v. Merit Mgmt. Grp.*, 541 B.R. 850, 852 (N.D. Ill. 2015), rev'd, No. 15-3388, 2016 WL 4036408 (7th Cir. July 28, 2016).

After the purchase, Valley View failed to obtain a gambling license as needed for its business plans and ultimately filed for bankruptcy. FTI Consulting, Inc. ("FTI"), the trustee of the litigation trust created pursuant to the Debtor's chapter 11 plan, filed an action against Merit alleging that the $16.5 million transfer was avoidable under sections 544, 548(a)(1)(b), and 550 of the Bankruptcy Code. Merit moved to dismiss on the grounds that the transfer was protected under section 546(e) of the Bankruptcy Code because it was made "by or to" a financial institution.

Procedural History:

The district court granted judgment on the pleadings pursuant to Federal Rule of Civil Procedure 12(c) in Merit's favor and held that the transfers were made "by or to" a financial institution because the funds passed through Citizens Bank and Credit Suisse. *FTI Consulting, Inc. v. Merit Mgmt. Grp.*, 541 B.R. 850 (N.D. Ill. 2015). FTI appealed.

Issue:

The Seventh Circuit framed the issue as "whether the section 546(e) safe harbor protects transfers that are simply conducted *through* financial institutions (or the other entities named in section 546(e)), where the entity is neither the debtor nor the transferee but only the conduit." 2016 WL 4036408 at *1 (emphasis in original).

Holding:

The Seventh Circuit held that the section 546(e) defense does not apply if the financial institution is merely a conduit for the funds.

Analysis:

The Seventh Circuit noted that the plain language of section 546(e), which protects certain transfers "made by or to (or for the benefit of)" certain types of counterparties to be ambiguous, as the phrase “made by or to” could plausibly be interpreted as referring only to the ultimate sender and recipient or to their respective intermediaries. Likewise, the phrase “or for the benefit of” could plausibly be interpreted as referring to transactions “on behalf of” another entity or to transactions merely involving an entity receiving an actual financial or beneficial interest. As the statute was unclear whether the defense applies to intermediaries or is limited to the “real parties in interest.” As a result, the Court turned to the statute’s context and purpose.

In reviewing the statute’s context, the Court analyzed the sections 544, 547, 548, 550 and 555 of the Bankruptcy Code, explaining that “[i]t makes sense to understand the [section 546(e)] safe harbor as applying to the transfers that are eligible for avoidance in the first place.” The Court reasoned that “the fact that sections 544, 547, and 548 permit avoidance only where the transfer represents an actual obligation means that 546(e) provides a safe harbor only where the debtor has incurred an actual obligation to the covered entity.” The Court also noted that an expansive reading of section 546(e) would eliminate the use of the section 548(c) defense except for transfers in cash, would render the section 548(d)(2) defense superfluous in all circumstances, and was inconsistent with the focus of the section 555 safe harbor on economic substance. In addition, the Court noted that the expansive reading of section 546(e) was not consistent with the section 550 provisions for recovery from mediate transferees, and that such a protection was not needed because of section 550’s good faith defense. The Court held that *Bonded Financial Services, Inc. v. European American Bank*, 838 F.2d 890, 893 (7th Cir. 1988), where the Court held that a “transferee” under section 550 is an entity with “dominion over the money,” similarly applies to section 546(e).

In reviewing the statute’s purpose, the Court explained that the intent of Congress was to protect the securities market from systemic risk and to prevent a bankruptcy from rippling through the securities industry. The Court noted that there was no concern with any such ripple effect by the return of the funds from Merit. The Seventh Circuit reasoned that, although the transfer between the Debtor and Merit resembled a leveraged buyout, and in that way involved the securities market, neither the Debtor nor Merit were parties in the securities industry. The Court concluded that it would not “interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds.”

The Court acknowledged that its holding conflicted with five other circuits (the Second, Third, Fifth, Sixth, and Tenth Circuits) and was consistent only with *In re Munford*, 98 F.3d 604, 610 (11th Cir. 1996). The Seventh Circuit rejected Merit’s argument that Congress disapproved of the *Munford* decision when it amended section 546(e) in 2006 to include “(or for the benefit of),” explaining that it did not believe that Congress would have “jettisoned *Munford’s* rule by such a subtle and circuitous route.”

Subsequent History:

On August 30, 2016, the Seventh Circuit denied Merit’s request for *en banc* review.

***Note Holders v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016)**

Background Facts:

Tribune Company ("Tribune" or the "Debtor") was acquired by Sam Zell in 2007 through a leveraged buyout involving $11 billion of debt secured by Tribune's assets. The $11 billion was used to refinance some of Tribune's pre-existing debt and to cash out shareholders at a premium to the share trading range. In relevant part, Tribune transferred $8 billion to a securities clearing agency to effectuate the cash out of its shareholders.

On December 8, 2008, Tribune filed for bankruptcy with liabilities exceeding its assets by more than $3 billion. In November 2010, the unsecured creditors' committee (the "Committee") filed claims against the Debtor's cashed-out shareholders, asserting that the transfers constituted intentional fraudulent transfers. The Committee did not assert constructive fraudulent transfer claims. After the two-year statute of limitations period to file fraudulent transfer actions expired, two groups of unsecured creditors ("Plaintiffs") filed state law constructive fraudulent transfer claims against the former shareholders. The shareholders moved to dismiss the state law fraudulent transfer claims on various grounds including that the claims were preempted by section 546(e) of the Bankruptcy Code.

Procedural History:

The district court held that the section 546(e) safe harbor did not preempt Plaintiffs' state law fraudulent transfer claims because the safe harbor applies only to bankruptcy trustees and Congress had declined to extend section 546(e) to state law fraudulent transfer claims brought by creditors. However, the district court dismissed Plaintiffs' claims for lack of standing, and both parties appealed.

Issue:

The Second Circuit framed the issue as whether Plaintiffs' state law fraudulent transfer claims were preempted because they conflicted with section 546(e) of the Bankruptcy Code.

Holding:

The Second Circuit affirmed the dismissal of Plaintiffs' claims, but on different grounds. Although the Court found that Plaintiffs had standing to assert the claims, the Court held that section 546(e) preempted Plaintiffs' state law fraudulent transfer claims.

Analysis:

The Second Circuit first discussed the implied preemption doctrine, under which federal law preempts state law to the extent of any conflict. The Court acknowledged that the presumption against preemption was strongest in areas traditionally left to state law, and noted that regulation of creditors' rights has a history of "significant federal presence" dating back to the enactment of the Constitution. The Court explained that "[o]nce a party enters bankruptcy, the Bankruptcy Code constitutes a wholesale preemption of state laws regarding creditors' rights." The Court also noted that section 546(e) reflected federal policies concerning the securities markets, which had been subject to extensive federal regulation for over eighty years, and this weighed against any presumption against preemption.

The Court next considered Plaintiffs' argument that fraudulent transfer claims revert to creditors if the trustee fails to enforce such claims during the two-year period under section 546(a)(1)(A). The Court found no basis or support in the Bankruptcy Code for this theory but concluded that it did not have to resolve that issue because the purpose and history of section 546(e) reflects Congress' intent to preempt state law fraudulent transfer claims.

The Court explained that Congress' purpose in enacting section 546(e) was to minimize the displacement caused in the commodities and securities markets in the event of bankruptcy and to promote finality and certainty for investors. The Court reasoned that "[a]llowing creditors to bring claims barred by section 546(e) to the trustee only after the trustee fails to exercise powers it does not have would increase the disruptive effect of an unwinding by lengthening the period of uncertainty for intermediaries and investors." The Court further noted that "the idea of preventing a trustee from unwinding specified transactions while allowing creditors to do so, but only later, is a policy in a fruitless search of a logical rationale." The Court therefore concluded that section 546(e) preempted state law fraudulent transfer claims by creditors.

***PAH Litigation Trust v. Water Street Healthcare Partners, L.P. (In re Physiotherapy Holdings, Inc.)*, 2016 WL 3611831, Case No. 15-51238 (KG) (Bankr. D. Del. June 20, 2016)**

Background Facts:

PAH Litigation Trust (the "Trust") asserted fraudulent transfer claims under state and federal law against various parties, including private equity funds Water Street Healthcare Partners L.P. and Wind Point Partners IV, L.P. (the "Defendants"), seeking to recover $248.6 million in payments made to various shareholders, including the Defendants, in exchange for their equity in Physiotherapy Holdings, Inc. ("PH" or the "Debtor") as part of a prepetition leveraged buyout.

The Trust alleged that Defendants engaged in accounting fraud for several years to overstate PH's financial health so that the Defendants could benefit from the eventual sale of Defendant's equity in PH. In connection with the leveraged buyout, PH assumed a large amount of new debt (which was based on the allegedly-inflated value of PH) without receiving anything of value in return, while the Defendants received $248.6 million in borrowed funds associated with the leveraged buyout. After PH defaulted on its secured obligations, it sought bankruptcy protection. Defendants moved to dismiss the complaint on several grounds, including that the transfers were protected by section 546(e) of the Bankruptcy Code.

Issue:

Does section 546(e) of the Bankruptcy Code preempt all state law fraudulent transfer claims by creditors?

Holding:

The Court held that section 546(e) does not prevent a trustee from asserting state law fraudulent transfer claims in its capacity as creditor-assignee when: (1) the transaction sought to be avoided poses no threat of "ripple effects" in the relevant securities markets, (2) the transferees received payment for non-public securities, and (3) the transferees were corporate insiders that allegedly acted in bad faith.

Analysis:

The Court reviewed several decisions addressing preemption in the context of section 546(e), including *In re Lyondell Chem. Co.*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014) and *In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98 (2d Cir. 2016). The Court adopted the holding of the *Lyondell* decision as its reasoning was persuasive and more accurate regarding the history and function of section 546(e).

The Court noted that states had traditionally addressed fraudulent transfer law and that the preemption analysis must "start with the *assumption that the historic police powers of the*

States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." (emphasis in original).

The Court pointed out that the legislative history explicitly stated the purpose of the safe harbors was to "mitigate the potential systemic risk of certain complex financial transactions." The Court concluded that allowing the Trust to pursue its state fraudulent transfer claims would not have a destabilizing effect on the financial markets and thus would not give rise to events that the safe harbor provisions were meant to protect against. The Court reasoned that it was hard to envision a scenario where requiring the Defendants to disgorge their payments would "pose any sort of 'ripple effect' to the broader secondary market."

The Court found further support for its holding in the plain language of the statute, explaining that section 546(e) only limits a trustee's ability to bring a fraudulent transfer action and is silent as to a creditor's ability to bring such a claim. The Court also considered the alleged bad faith of the Defendants, noting that "[p]ermitting a defendant to evade liability in this scenario vis-à-vis the safe harbor would run counter to Congress' policy of providing remedies for creditors who have been defrauded by corporate insiders," and did not accept that "Congress intended to protect bad-faith transferees in situations such as this."

The Court concluded that section 546(e) did not preempt creditors from asserting state law fraudulent transfer claims when: "(1) the transaction sought to be avoided poses no threat of 'ripple effects' in the relevant securities markets; (2) the transferees received payment for non-public securities, and (3) the transferees were corporate insiders that allegedly acted in bad faith."

In re ICL Holding Co., et al.**, 802 F.3d 547 (3d Cir. 2015).**

Background Facts:

Before entering bankruptcy, LifeCare Holdings, Inc. and certain of its subsidiaries (the "Debtors") reached an arrangement with their secured lender group (the "Secured Lenders") by which the Secured Lenders would acquire substantially all of the Debtors' assets, including cash, pursuant to a sale under section 363 of the Bankruptcy Code. This arrangement was memorialized in an Asset Purchase Agreement (the "APA") executed the day before the Debtors filed their voluntary petitions under Chapter 11 of the Bankruptcy Code. The APA contemplated that the Secured Lenders would credit bid $320 million of the $355 million of their secured claims. Furthermore, the Secured Lenders agreed to place additional cash into escrow to pay certain administrative fees and wind-down costs of the Debtors' bankruptcy cases (the "Escrowed Funds"), including fees and expenses incurred by the committee of unsecured creditors (the "Committee"), with any unspent funds to be returned to the Secured Lenders.

Once in bankruptcy, the Debtors attempted to attract higher offers pursuant to a court-approved marketing process. Finding none, the Debtors then sought court approval of the proposed sale to the Secured Lenders pursuant to the APA (the "Sale"). Both the Committee and the United States objected on the basis that the Sale would leave the estate administratively insolvent and claims owed to the United States and the constituents of the Committee would go unpaid. The United States asserted that the approximately $24 million in capital gains tax liability resulting from the Sale, which would be entitled to administrative priority under a plan of reorganization, would not be paid as a result of the sale despite the payment of certain administrative claims from the Escrowed Funds.

The Secured Lenders and the Committee reached a settlement of the Committee's objection by which the Secured Lenders agreed to pay $3.5 million to the unsecured creditors (the "Settlement"). The Settlement was submitted to the Bankruptcy Court for approval. The United States objected to the Settlement on the basis that it was a payment to unsecured creditors while its administrative claims would remain unpaid in violation of the absolute priority rule.

Procedural History:

The Bankruptcy Court considered the Settlement and the Sale separately.

The Bankruptcy Court approved the Sale on the bases that the Secured Lenders' offer was the only opportunity to avoid a liquidation of the Debtors in light of the Debtors' deteriorating financial situation. The Court noted that a liquidation would have a negative impact on patients and would not result in any payments to the United States or unsecured creditors on account of their claims. Accordingly, there was a sound business purpose to justify the Sale. In response to the United States' objection regarding the Escrowed Funds, the Court overruled the objection and held that the Escrowed Funds, which were separately funded by the Secured Lenders, and were not estate property and therefore were not subject to the Bankruptcy Code's distribution scheme with respect to the Debtors' creditors.

The Bankruptcy Court later approved the Settlement. The Bankruptcy Court overruled the United States' objection that the Secured Lenders' payment to the unsecured creditors to resolve the Committee's Sale objection was compensation received in connection with the Sale and therefore part of the Debtors' estates and subject to the Bankruptcy Code's distribution scheme. The Bankruptcy Court disagreed and held that because the funds were paid directly from the Secured Lenders to the unsecured creditors they did not become part of the Debtors' estates, and therefore the absolute priority rule was not implicated.

The United States appealed both decisions and sought a stay of the sale and of the settlement to preserve the status quo pending resolution of the appeals. The stays were denied in the Bankruptcy Court, and the District Court consolidated the appeals and affirmed.

The United States appealed to the U.S. Court of Appeals for the Third Circuit (the "Third Circuit").

Issues:

The Third Circuit framed the two issues as did the Bankruptcy Court err in approving:

- a provision of the Sale of Debtors' assets under which the Secured Lenders agreed to pay some administrative claims but not others of equal priority?
- the distributional terms of the Settlement, which resulted in a $3.5 million payment for unsecured creditors even though a senior creditor—namely the United States—received nothing?

Holding:

The Third Circuit held the Bankruptcy Court did not err in approving the Sale and the Settlement because neither (i) the Escrowed Funds nor (ii) the funds paid to unsecured creditors pursuant to the Settlement (collectively, the "Disputed Funds") were property of the Debtors' estates. Accordingly, the Bankruptcy Code's priority of distribution did not apply.

Analysis:

Before reaching the merits, the Third Circuit first satisfied itself that the appeal was not constitutionally, statutorily, or equitably moot. The appeal was not constitutionally moot because the United States had a legally cognizable interest in the outcome, however unlikely or remote given the lack of assets remaining in the Debtors' estates. The appeal was not statutorily moot under section 363(m) because the United States merely sought a redistribution of the funds from the Sale, it did not seek to claw back the Sale from a good faith purchaser. Finally, the Third Circuit held that it would not extend the doctrine of equitable mootness beyond the plan context.

Moving to the merits, the Third Circuit agreed with the Bankruptcy Court and District Court that both issues turned on whether the Disputed Funds were property of the Debtors' estates. The Bankruptcy Code includes in property of the estate "proceeds . . . of or from property of the estate." 11 U.S.C. §541(a)(6). Therefore, if the Disputed Funds were not proceeds of the Sale of estate property, the decisions below must be affirmed.

With respect to the funds paid to unsecured creditors pursuant to the Settlement, the Third Circuit found it decisive that the money paid to unsecured creditors was paid directly to the unsecured creditors from a trust funded by the Secured Lenders and never became property of the estate. Nor was it paid at the Debtors' direction. The Third Circuit rejected the United States' argument that the funds from the Settlement were proceeds from the Sale because they were paid to resolve the Committee's objection to the Sale and ensure the success of the Secured Lenders' purchase of the Debtors' assets. "[T]he settlement sums paid by the [Secured Lenders] were not proceeds from its liens, did not at any time belong to LifeCare's estate, and will not become part of its estate even as a pass-through." *ICL Holding Co.*, 802 F.3d at 556. This result was not affected by a statements by the Committee that it was receiving "proceeds derived from the sale." *Id*. The Third Circuit founds that in substance and form, the unsecured creditors were not receiving proceeds from the estate, but property from the Secured Lenders.

The Third Circuit also disagreed with the attempts by the United States to cast the Escrowed Funds as part of the purchase price for the Debtors' assets. The Third Circuit held that proceeds of property of the estate do not include all property a buyer gives up to acquire property from the estate, but only the property actually received by the estate in exchange for estate property relinquished. The Third Circuit viewed the Sale narrowly as an exchange of all of the Debtors' assets, including all cash, for forgiveness of $320 million in secured claims against the Debtors. The Escrowed Funds remained property of the Secured Lenders (and were returned to them) to the extent they were not distributed to pay certain administrative fees and wind-down costs as set forth in the APA.

Though the United States did not make this argument, the Third Circuit also considered whether the Escrowed Funds should be treated as an ordinary carve-out, by which secured creditors in bankruptcy cases permit a portion of their collateral to be set aside for payment of administrative claims. Such property would be considered to be estate property. But, because the Escrowed Funds came from a source other than the Secured Lenders' collateral, the Third Circuit held that it could not be treated as a carve-out.

As a result of its conclusions that the Disputed Funds were not property of the Debtors' estates, the Third Circuit had no need to consider whether the priority scheme of the Bankruptcy Code was implicated in a sale under section 363.

***Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund,* 2016 BL 95418 (D. Mass. Mar. 28, 2016)**

Background Facts:

Plaintiffs private equity funds Sun Fund III and Sun Fund IV[1] (the "Sun Funds") owned Scott Brass, Inc. ("SBI") at the time of its bankruptcy and cessation of payments into the New England Teamsters & Trucking Industry Pension Fund (the "Pension Fund"). Ceasing its payments to the Pension Fund created withdrawal liability for SBI and any other entity with which it could be classified as a "single employer" under relevant provisions of the Multiemployer Pension Plan Amendments Act (the "MPPAA"). Under the MPPAA, separate businesses are treated as a single employer if they are "trades or businesses" and are "under common control." 29 U.S.C. §1301(b)(1). The Sun Funds sought a declaratory judgment that they are not liable to the Pension Fund for this withdrawal liability, and the Pension Fund filed a counterclaim seeking to hold the Sun Funds jointly and severally liable for SBI's withdrawal liability.

Sun Fund III and Sun Fund IV did not own SBI directly, instead owning 30% and 70%, respectively, of Sun Scott Brass, LLC. Sun Scott Brass LLC owns Scott Brass Holding Corp., which in turn owned SBI. The general partners of each of the Sun Funds were themselves limited partnerships: Sun Capital Advisors III, LP, and Sun Capital Advisors IV, LP. Private equity firm Sun Capital Advisors, Inc. ("SCAI") arranged and structured the Sun Funds. The Sun Funds themselves had no employees or offices of their own.

The general partners of the Sun Funds were entitled to annual management fees calculated as a percentage of assets contributed to each fund. These fees could be waived by the general partners, giving them a credit against future capital calls. Management fees could also be offset by the amount of other fees. For example, Sun Capital Partners Management IV, LLC ("SCP Management IV"), a subsidiary of the general partner of Sun Fund IV, contracted with Scott Brass Holding Corp. to provide management and consulting services regarding SBI's business in exchange for fees. Management fee offsets generated by payments to SCP Management IV were allocated 70% to Sun Fund IV and 30% to Sun Fund III. When more offsets were generated than could be used—due to the waiver of management fees or otherwise—management fee offset carryforwards were created that could be applied to reduce the future payment of management fees.

Procedural History:

Considering cross motions for summary judgment, the U.S. District Court for the District of Massachusetts (the "District Court") granted summary judgment in favor of the Sun Funds because it held that neither of the Sun Funds were "trades or businesses" under the MPPAA. As a result of this holding, the District Court did not go on to consider the issue of common control.

The Pension Fund appealed to the U.S. Court of Appeals for the First Circuit (the "First Circuit"). On appeal, the First Circuit applied a fact-specific test that it called the "investment

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[1] Sun Capital Partners III, LP is referred to as "Sun Fund III" and Sun Capital Partners IV, LP is referred to as "Sun Fund IV."

plus test" to the undisputed facts and held that Sun Fund IV was a trade or business as that term is used in the relevant provision of the MPPAA. The First Circuit remanded the case back to the District Court for further fact development relevant to whether Sun Fund III was a trade or business and to consider the element of common control.

Both the Sun Funds and the Pension Fund filed renewed cross motions for summary judgment in the District Court.

Issues:

First, did Sun Fund III receive an economic benefit, as the First Circuit ruled that Sun Fund IV did, that an ordinary passive investor would not receive—and thus, under the test articulated by the First Circuit, was Sun Fund IV engaged in a trade or business under the MPPAA?

Second, were the Sun Funds under common control with SBI under the meaning in the MPPAA?

Holding:

First, the District Court found that Sun Fund III received the same economic benefit received by Sun Fund IV, in the form of an offset against the management fees it otherwise would have paid its general partner for managing the investment in SBI. The District Court noted that these were benefits that an ordinary passive investor would not receive. As such, under the "investment plus test" applied by the First Circuit, Sun Fund III was engaged in a trade or business.

Second, though the Sun Funds individually did not satisfy the common control test under the MPPAA, they collectively formed a partnership which itself was under common control with SBI. Furthermore, the partnership itself was engaged in a trade or business, and therefore the Sun Funds were subject to withdrawal liability under the MPPAA.

Analysis:

"[U]nder the MPPAA, [t]o impose withdrawal liability on an organization other than the one obligated to the [pension] Fund, two conditions must be satisfied: 1) the organization must be under common control with the obligated organization, and 2) the organization must be a trade or business.'" *Sun Capital* at 2 (D. Mass.) (internal quotation marks omitted) (*quoting Sun Capital Partners III, LP. v. New England Teamsters & Trucking Indus. Pension Fund*, 724 F.3d at 138 (1st Cir. 2013).

In determining whether an investor was involved merely in a passive investment or a trade or business for the purposes of the MPPAA, the First Circuit explained that a fact specific "investment plus" approach was appropriate. Though it declined to specify what made up the "plus" factors in all cases, the First Circuit concluded that Sun Funds IV was a trade or business due to the following facts (common to both of the Sun Funds):

> The Sun Funds make investments in portfolio companies with the principal purpose of making a profit . . . [T]he Sun Funds have also undertaken activities as to the SBI property. The Sun Funds' limited partnership agreements and private placement memos explain that the Funds are actively involved in the management and operation of the companies in which they invest . . . . Each Sun Fund agreement states, for instance, that a "principal purpose" of the partnership is the "manag[ement] and supervisi[on]" of its investments. The agreements also give the general partner of each Sun Fund exclusive and wide-ranging management authority . . . the Sun Funds' controlling stake in SBI placed them and their affiliated entities in a position where they were intimately involved in the management and operation of the company . . . through a series of appointments, the Sun Funds were able to place SCAI employees in two of the three director positions at SBI, resulting in SCAI employees controlling the SBI board.

Sun Capital at 2-3 (D. Mass.) (quoting *Sun Capital* at 141-43 (1st Cir.).

As the District Court explained, the undisputed facts presented in the renewed cross-motions for summary judgment showed that Sun Funds III received the same economic benefit that Sun Fund IV received, namely, management fee offsets or offset carryforwards. An ordinary passive investor would not receive that kind of benefit. Though the Sun Funds argued that the First Circuit erred when it concluded that offset carryfowards provided an actual economic benefit to Sun Fund IV—and, therefore, offset carryforwards were irrelevant as to Sun Fund III—the District Court explained that it could not overturn the law of the case as set down by the First Circuit. But even if it could, the District Court disagreed that the potential or actual worthlessness of the carryforwards made them economically worthless. The District Court refused to "adopt the proposed test which makes the receipt of an 'economic benefit' contingent on factors that are either arbitrary or irrelevant to the ultimate determination that [the court] must make—whether the Sun Funds were engaged in trade or business." *Id.* at 8.

As to "common control," the Pension Benefit Guaranty Corporation adopted regulations referencing the tax code's definition of "common control" set forth in 26 U.S.C. §414(c). Under applicable tax regulations, common control includes a parent-subsidiary group, a brother-sister group, or a combined group. As relevant to the Sun Funds' relationship to SBI, a parent-subsidiary group requires the parent entity to own a controlling interest, defined in applicable regulations as 80% ownership in the subsidiary. *Sun Capital* at 8 (D. Mass.) (citing 26 C.F.R. §1.414(c)-2(b).

Neither of the Sun Funds individually own 80% of SBI, a structure the Sun Funds admit was chosen specifically to avoid withdrawal liability under the MPPAA. Additionally, the Sun Funds explicitly disclaimed any intent to enter into a partnership or joint venture when they made their investments into SBI or any other portfolio company. Nevertheless, the Pension Fund argued, and the District Court agreed, that that the Sun Funds intended to "join together for the purpose of carrying on business and sharing in the profits or losses or both." *Id.* at 13. As such, they were properly regarded as having formed a partnership under federal tax law and thus under the MPPAA.

In sum: the Sun Funds carried on trades or benefits under the MPPAA, but did not individually share common control with SBI. SBI shared common control with the partnership deemed to have been formed between the Sun Funds, but was the Sun Funds partnership itself a trade or business? The District Court believed that yes, it was. Accordingly, it—and also its partners—properly faced withdrawal liability under the MPPAA.

In re Aéropostale, Inc., et al., Case No. 16-11275 (Bankr. S.D.N.Y. Aug. 26, 2016)

Background Facts:

Sycamore Partners ("Sycamore") is a private equity firm that acquired various interests in Aéropostale, Inc. ("Aéropostale") at various times prior to the bankruptcy filing of Aéropostale and certain of its affiliates (collectively, the "Debtors") in May, 2016. Sycamore affiliate Lemur LLC ("Lemur") purchased approximately 8% of the Aéropostale's common stock in 2013 and sold all of it in February, 2016. Sycamore funds own a majority in MGF Sourcing Holdings, Limited ("MGF Holdings"), parent of TSAM (Delaware) LLC (d/b/a MFG Sourcing US LLC) ("MGF"), one of the Debtors' two largest suppliers. MGF Holdings and Aero Investors LLC ("Aero Investors" and, together with MFG Holdings, the "Term Lenders") provided a secured term loan to the Debtors.

In 2014, the Debtors explored a variety of options to fuel a turnaround and avoid bankruptcy, including (but not limited to) several financing options proposed by Sycamore. The Debtors ultimately chose to enter into a two-tranche term loan agreement (the "Prepetition Term Loan Agreement") funded $100 million by Aero Investors (Tranche A) and $50 million by MGF Holdings (Tranche B). Tranche A carried 10% interest and Tranche B carried 0% interest with regular principal payments over ten years. The Prepetition Term Loan Agreement included a $70 million minimum liquidity covenant and involved a sourcing agreement with MGF (the "Sourcing Agreement"). The Sourcing Agreement was a key feature causing the Debtors to choose this particular financing option. The Sourcing Agreement also contained a $150 million liquidity trigger that permitted MGF to declare a "Credit Review Period" during which MGF was permitted to adjust its payment terms from "net 30 days" to payment terms reasonably acceptable to MGF.

The Debtors' performance continued to deteriorate through 2015 and early 2016. The reactions of Sycamore Partners and its affiliates to the Debtors' financial condition form the factual basis for the Debtors' arguments. Lemur completed its sale of Aéropostale stock on February 8, 2016, recouping approximately $1 million of its $54 million investment. The Term Lenders concluded in February, 2016 that the Debtors were likely below the $150 million liquidity threshold, and the Debtors confirmed that analysis on February 11, 2016, indicating that it had a borrowing base of approximately $131 million. On February 24, MGF declared a Credit Review Period under the Sourcing Agreement and notified the Debtors that they must find a new source of liquidity or payment for new orders would be due upon order placement, up to 90 days prior to delivery. On February 29, MGF notified the Debtors that pending orders would not be shipped until payment in full was received.

Procedural History:

After filing their voluntary petitions under Chapter 11 of the Bankruptcy Code on May 4, 2016, the Debtors filed a motion in the U.S. Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") seeking to alter the rights that ordinarily would be available to the Term Lenders as secured creditors of the Debtors in bankruptcy.

Note that although the Debtors disputed certain of MGF's actions prior to the petition date, those disputes were resolved by settlement approved by the Bankruptcy Court under Federal Rule of Bankruptcy Procedure 9019 on May 24, 2016. MGF and the Debtors have now terminated their relationship.

Issues:

1. Were the acts of the Term Lenders and their affiliates so inequitable and harmful to the

Debtors and their creditors that the Term Lenders' claims must be equitably subordinated?

2. Based on those acts, should the Term Lenders be disqualified from credit bidding their claims to acquire the Debtors' assets?

3. Should Tranche B under the Prepetition Term Loan Agreement be recharacterized as equity?

Holding:

1. The Debtors did not prove sufficient inequitable misconduct by the Term Lenders to support equitable subordination. Contrary to the Debtors' arguments, the Term Lenders did not, by breach of the Prepetition Term Loan Agreement, launch a secret plan to improperly push the Debtors into bankruptcy in order to cheaply acquire the company, or cause the type of harm to the Debtors or their creditors caused by alleged insider trading that would support equitable subordination of claims in bankruptcy.

2. For similar reasons, although pursuant to a different standard, the Bankruptcy Court refused to disqualify the Term Lenders from credit bidding because the Debtors' allegations, even if true, would not support a conclusion that the Term Lenders gained an unfair advantage in the sale process.

3. Tranche B of the Prepetition Term Lending Agreement should not be recharacterized as an equity contribution merely because Tranche B accrued no interest, where the remaining ten factors in the eleven-factor test were either inconclusive or weighed against recharacterization.

Analysis:

At its core, this case is about fairness. "Bankruptcy courts 'have broad equitable powers and the ability to invoke equitable principles to achieve fairness and justice in the reorganization process.'" Aéropostale, at 24 (quoting LightSquared LP v. SP Special Opportunities LLC (In re LightSquared Inc.), 511 B.R. 253, 346 (Bankr. S.D.N.Y. 2014)). The Term Lenders, like many secured creditors in modern Chapter 11 practice, held considerable influence over the Debtors' bankruptcy cases. To the Debtors, this influence was earned unfairly as part of a coordinated plan executed by the Term Lenders and their affiliate entities controlling one of the Debtors' major suppliers and owning a significant minority of Aéropostale's shares. The Debtors argued that the imposition of highly unfavorable payment terms by MGF and the dumping of equity shares by Lemur in February 2016 were orchestrated by Sycamore Partners to force the Debtors into bankruptcy from which the Term Lenders could acquire the company cheaply via a credit bid at a section 363 sale.

The Term Lenders, however, asserted that each of these actions was a rational response taken by each individual entity looking out for its own interests. To the extent the Term Lenders gained any advantage, they came by it fairly and largely as a result of transactions entered into willingly and at arms length by the Debtors.

The Bankruptcy Code provides for equitable subordination in section 510(c), but it is an "extraordinary remedy that is to be used sparingly." Aéropostale, at 25 (quoting In re Sabine Oil & Gas Corp., 547 B.R. 503, 564 (Bankr. S.D.N.Y. 2016)). The test for equitable subordination predates the Bankruptcy Code and requires a showing of three elements: "(i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act." Id. at 25 (quoting Benjamin v.

Diamond (In re Mobile Steel Corp.), 563 F.2d 692, 699-700 (5th Cir. 1977)). The third factor is less relevant given equitable subordination's adoption into the bankruptcy code.

The Bankruptcy Court applied the standard for equitable subordination of the Term Lenders' interests to each of the transactions at issue and held that the Debtors failed to establish the kind of inequitable conduct or harm required to support equitable subordination. There was no breach of the Sourcing Agreement because the advance payment terms imposed by MGF were within its rights under the Sourcing Agreement pursuant to the valid Credit Review Period triggered by the Debtors' declining liquidity. There was no credible evidence of an improper secret plan by Sycamore Partners to acquire the Debtors; instead, the actions of the various Sycamore Partners' affiliates were consistent with those of a concerned investor, lender, and supplier[2] with considerable exposure to the Debtors' performance. There was no theory establishing that sales of Aéropostale's stock injured creditors or gave Sycamore Partners an advantage, nor did the Bankruptcy Court believe that the alleged inside information supporting the trades was sufficiently material. The Bankruptcy Court therefore denied the motion with respect to equitable subordination.

The Bankruptcy Court next considered whether the Term Lenders should be permitted to credit bid for the Debtors' assets. The Bankruptcy Code does not specify the circumstances under which a lender would be prevented from credit bidding, only specifying that a court may so order "for cause." 11 U.S.C. §363(k). The Bankruptcy Code does not define "cause," allowing courts to consider the facts of each case when determining whether to disallow credit bidding. The Bankruptcy Court pointed out several common features of cases in which secured lenders were not permitted to credit bid, such as "inequitable conduct" and "conduct that also directly impacts the estate or the bidding process," situations in which "the validity of a creditor's lien is in dispute," or when the secured party "has failed to comply with the procedural requirements established by the court for the sale of the collateral." Aéropostale, at 43-44.

Based largely on the same facts supporting its denial of equitable subordination, the Bankruptcy Court refused to disqualify the Term Lenders from credit bidding. The evidence presented at trial did not support a finding of inequitable conduct or unfair control of the sale process. The Debtors also argued that credit bidding would drive away competitive bids, but this factor, standing alone, was insufficient under the case law to disallow credit bidding. Furthermore, the evidence submitted at trial indicated that an active sale process was already underway, involving many parties other than the Term Lenders.

Finally, the Bankruptcy Court considered whether to recharacterize Tranche B of Prepetition Term Loan Agreement from debt to equity, applying an 11-factor test:

(1) the names given to the instruments, if any, evidencing the indebtedness;

(2) the presence or absence of a fixed maturity date and schedule of payments;

(3) the presence or absence of a fixed rate of interest and interest payments;

(4) the source of repayments;

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[2] In fact, Sycamore Partners did not control a majority of MGF's board of directors at the time that the Debtor entered into the Sourcing Agreement.

(5) the adequacy or inadequacy of capitalization;

(6) the identity of interest between the creditor and the stockholder;

(7) the security, if any, for the advances;

(8) the corporation's ability to obtain financing from outside lending institutions;

(9) the extent to which the advances were subordinated to the claims of outside creditors;

(10) the extent to which the advances were used to acquire capital assets; and

(11) the presence or absence of a sinking fund to provide repayments.

Aeropostale, at 49 (quoting Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726 (6th Cir. 2001).

Only factor three, the lack of interest, favored recharacterization. Factors one, two, four, six, seven, eight, nine, and ten weighed against recharacterization. The Debtors argued that the loan was made when it was inadequately capitalized (factor five) and the Term Lenders were affiliates of a stockholder (factor six). But the Bankruptcy Court was unwilling to give much weight to the Debtors' lack of capital, observing that all companies that wind up in bankruptcy are likely undercapitalized when they receive prepetition financing intended to fund a turnaround. It also did not find the affiliation between the Term Lenders and holders of a minority of Aéropostale's publicly issued stock to be strong enough to weigh factor six in the Debtors' favor. Taken as a whole, then, the eleven factors did not support recharacterization.