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CREDITOR DISPUTES IN BANKRUPTCY

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HOT TOPIC

CREDITOR DISPUTES IN BANKRUPTCY

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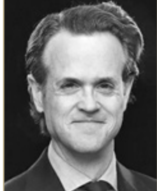

Eli J. Vonnegut
Partner
Davis Polk & Wardwell LLP
T: +1 (212) 450 4331
E: eli.vonnegut@davispolk.com

Eli J. Vonnegut is a partner who represents multiple types of clients in restructuring and finance transactions. He advises numerous financial institutions on Dodd-Frank resolution planning. He represents creditors, debtors, agent banks, hedge funds, lenders, bondholders and other strategic parties in a range of corporate restructurings, financing transactions, bankruptcy litigation, asset sales and acquisitions. He also advises clients on matters relating to investments in complex distressed businesses.

Michael Handler
Partner
King & Spalding
T: +1 (212) 556 2286
E: mhandler@kslaw.com

Michael R. Handler is a partner in King & Spalding's financial restructuring and private credit and special situations practice. He specialises in representing lenders, bondholders and borrowers in all aspects of workout and restructuring matters. He also has significant experience representing financial institutions, institutional investors and large corporations in distressed commercial finance transactions, mergers & acquisitions and other corporate transactions.

Susheel Kirpalani
Chair, Bankruptcy & Restructuring Disputes
Quinn Emanuel Urquhart & Sullivan, LLP
T: +1 (212) 849 7200
E: susheelkirpalani@quinnemanuel.com

Susheel Kirpalani is the founder and chairperson of Quinn Emanuel Urquhart & Sullivan's bankruptcy and restructuring group. His notable representations over nearly three decades have included debtor-creditor and intercreditor disputes across virtually every industry. He testified before US Congress on the fairness of bankruptcy legislation for US territories, and led creditors to the first successful restructuring of bonds in Puerto Rico. He has also served as a court-appointed examiner and mediator of creditor disputes.

Van C. Durrer
Partner
Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates
T: +1 (213) 687 5200
E: van.durrer@skadden.com

Van C. Durrer leads Skadden's corporate restructuring practice in the western US and advises clients in restructuring matters around the Pacific Rim. Mr Durrer regularly represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, investors and asset purchasers in troubled company M&A, financings and restructuring transactions, including out-of-court workouts and formal insolvency proceedings.

CD: How frequently are you seeing creditor disputes, or 'creditor-on-creditor violence', surfacing during bankruptcy proceedings in the current market?

Vonnegut: Creditor disputes have long been common in any bankruptcy in which unsecured or undersecured creditors are facing low or zero recoveries, and the estate or those creditors are able to fund a fight over value allocation. In failed leveraged buyouts this can take the form of fraudulent transfer litigation, while in more vanilla bankruptcies it would centre around valuation and the scope of secured creditors' collateral coverage. What is newer is the prevalence of bankruptcies that follow out-of-court liability management transactions that themselves were contested by creditors that chose not to participate or were excluded from those transactions and were disadvantaged by losing collateral or having their claims or liens subordinated to other creditors. What we are seeing now is the pre-bankruptcy disputes about the validity of these transactions morphing into attacks on participating creditors' lien and claim positions during the bankruptcy that follows.

Kirpalani: I would not say that every Chapter 11 case includes 'creditor-on-creditor violence', but there has definitely been an uptick in the larger, more complex cases whereby creditors use their position in the capital structure to advance their recoveries by disadvantaging those further down the food chain. But while some lawyers see this as a negative, I see it as just the next version of what well-heeled creditors have always done – used their senior status to maximise their returns. The reason people are noticing it now, or believe it to be different, is that creditors within the senior-most debt instruments are, in effect, cannibalising each other through what some believe are 'loopholes' in documents to permit amendments that are contrary to the spirit of ratable treatment within a loan product. Others take the view that these broad rights to amend were specifically bargained for, pointing to the much stricter requirements for amending loan documents that existed in the aftermath of the financial crisis of 2008-09.

Durrer: As capital structures have become more complex and more leveraged, 'creditor-on-creditor violence' has become more prevalent. Until recently, prevailing modest interest rates have allowed companies to use leverage to provide necessary liquidity and flexibility. Of course, more leverage restricts flexibility and creativity as fewer options exist as interest rates rise, and companies find themselves in need of more liquidity. In past cycles involving less leverage, companies could work cooperatively with stakeholders to develop consensus-driven solutions to their balance sheet

problems. Today, there is precedent that suggests that it is sometimes more efficient for companies to choose among the best-positioned creditors in the capital stack to attract additional funding to the disadvantage of others, which may lead to intercreditor litigation.

Handler: 'Creditor-on-creditor violence' generally refers to majority creditors leveraging their position as the 'required lenders' to participate in, or consent to, a liability management transaction that provides the majority group with special economics rights, usually at the expense of the minority lenders. Whereas at one point these types of transactions were the 'exception to the rule', they are now more commonplace and generally considered a potential option as part of a company's evaluation of liability management alternatives. Disputes among creditors within different classes – such as first lien versus second lien and secured versus unsecured – have always been a part of the Chapter 11 process; now intra-class, or lenders previously within the same class, disputes add an additional complexity and uncertainty to the restructuring process.

CD: What are the common issues that arise in legal battles among creditors? Could you highlight any recurring themes?

Kirpalani: The most common issue is whether a particular 'liquidity transaction', such as a new loan or refinancing issued by a borrower in order to weather perceived temporary financial stress, was permitted by the terms of each debt instrument of the borrower. The first step is to ask whether any so-called 'sacred rights' were violated. A 'sacred right' is a change to a loan's terms that requires each affected lender's consent in order to be valid against that lender. The paradigm would be the right to be repaid at maturity. This right is typically sacrosanct and not waivable by others because it is the essence of the bargain between debtor and creditor. From that springs questions about what else constitutes the essence of the bargain: maintaining priority of liens, releasing liens, permitting additional debt,

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permitting additional liens, purchasing or exchanging only select holders' debts. A company in financial distress needs to borrow more money and to do so must amend its existing loan documents. If the company can obtain the requisite votes then it can do so freely as long as it does not violate other lenders' sacred rights or some other requirement to treat all lenders exactly the same. Another recurring issue is whether the company's refinancing involved a 'redemption' of debt, which must be done pro rata, or whether it was merely an 'exchange' or 'purchase' in the open market, which the company has flexibility to do. The typical legal claims asserted are breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent transfer or insider preferences, unjust enrichment, breach of fiduciary duty and tortious interference with contract.

Durrer: The common issues that arise in legal battles among creditors centre around textual arguments based on the underlying documents that govern their respective rights, contentions that focus on whether the parties have ignored their obligations of good faith and fair dealing which typically arise under Delaware or New York law, and valuation metrics, especially where collateral may have been transferred beyond the reach of certain creditor constituencies. Textual arguments are routinely resolved through a dispositive motion, but questions of good faith and valuation often require discovery and months of litigation. In the next generation of documentation governing intercreditor rights, we should anticipate a tightening of such documentation to reduce the number of issues that can be litigated through discovery.

Handler: Common issues include whether the relevant transaction complies with the operating credit documents, including whether it was a proper 'open market' transaction, whether the objecting creditors have contractual standing to file the underlying lawsuit or are barred by a 'no-action' clause in the loan agreement, and whether there are other potential claims that could survive a motion to dismiss in addition to breach of contract claims. Aside from the four corners of the litigation, there is also the interplay of how a Chapter 11 proceeding affects or may affect the legal battle. Is there a pending lawsuit prior to the Chapter 11, like in *Serta*? Was the lawsuit filed after the Chapter 11 was commenced, like in *Envision*? With respect to intercreditor disputes that implicate the debtor's business judgment, such as the reasonableness and necessity of financing and backstop fees, the equitable and practical dynamics at play, including support from other stakeholders, like the creditors' committee, will be important factors in assessing the bona fides of the underlying transaction.

Vonnegut: The recurring theme is junior creditor tenacity and creativity. Fundamentally, junior creditors seeking to enhance their recoveries in a bankruptcy that follows a liability management exercise must either uncover unknown unencumbered value, which is very challenging when the debtor was motivated to pledge all such value in the pre-bankruptcy transaction to secure new liquidity, or strip value from creditors that participated in the transaction. And so, in addition to the standard unsecured creditors committee or junior creditor playbook of lien and valuation challenges, we are now seeing more contractually driven litigations, in which arguments are similar to those raised against liability management transactions out of bankruptcy but grafted onto the bankruptcy context to seek invalidation of the enhanced positions participating creditors received. We have not seen these attacks succeed, and we do not expect them to for well-structured transactions, but they can generate sufficient noise and delay to drive small settlements.

CD: What criteria determine which creditors are given priority in a bankruptcy case? What are the implications for how participating vs non-participating creditor groups are positioned in a turnaround scenario, for example?

Durrer: Historically, creditor priority was based primarily on statute and contractual agreement. In today's economic environment, which is driven in large part by private equity and private lending, the market forces have changed the dynamic. Regulated financial institutions no longer lead the charge. Rather, it is the financial cycle of private money. As such, creditors sometimes make decisions based not on what is the best solution for a given credit, but instead what other forces influence the creditor such as what compromises it is permitted to undertake, what securities it can hold, whether it is capable of investing new funds to preserve a going concern, and so on. More importantly, a dynamic has emerged where new money is favoured over existing 'borrowed money'. In other words, new investors are rewarded, many at the expense of earlier investors.

Vonnegut: In both out-of-court liability management transactions and in bankruptcies, the old rule holds that whoever steps up to provide the debtor a path forward gets the best available position in the capital structure and is best positioned for success. In a liability management context, this can mean a new senior position with priority over non-participating creditors, through lien subordination or structural priority, and in bankruptcy it means the full suite of protections available for debtor in possession (DIP) lenders including the ability to absorb any unencumbered

value and to shape a plan process. In an out-of-court turnaround, non-participating creditor groups are making a bet: that they will either successfully block the transaction from happening and trigger a near-term bankruptcy or that by holding out they will be paid in full without making concessions. Recent bankruptcies have shown that efforts by non-participating creditors to attack and unwind pre-bankruptcy liability management transactions face real challenges.

Handler: At a very high level, priorities are determined based on three main points: secured and unsecured status and lien priority based on state law and terms of operative contracts, asset value of the debtor obligor as of the petition date, and as of the date of a 363 sale and plan confirmation, and the cost of new capital and dilutive effect on prepetition creditors borrowed as DIP and exit financing. The first two of these factors often results in lower recoveries for non-participating creditor groups.

Kirpalani: The criteria governing priority in bankruptcy are as old as time. Creditors with the senior-most liens on property must be paid the value of that property before anyone else can share in it. Creditors without liens, or with junior liens on the borrower's assets, simply share in whatever residual value is available for distribution to creditors. Participating creditors will be the owners of the senior-most liens, whereas non-participating creditors will either have junior liens or no liens at all. Often, this means the senior-secured creditors obtain all the value of the reorganised company, except for possibly a tip to junior creditors and the opportunity for management to receive equity incentive compensation. Moreover, it is ubiquitous for the senior-most creditors to be the providers of DIP financing, which gives them a greater say in the duration of the Chapter 11 case and any milestones that may be desirable for a speedy exit.

> **"Time-tested settlement strategies continue to be employed successfully in creditor-on-creditor disputes between the 'haves' and 'have nots', provided the 'haves' are willing."**
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> *Quinn Emanuel Urquhart & Sullivan, LLP*

CD: What options or protections, if any, might exist for minority lenders subordinated by other creditors?

Handler: There are various protections that can be negotiated in loan agreements that mitigate the risk of certain liability management transactions. For example, after J. Crew consummated a 'drop down' financing transaction, whereby it moved valuable trademarks to an unrestricted subsidiary, lenders

started negotiating restrictions on moving 'crown jewel' assets to unrestricted subsidiaries. With respect to uptier or priming financing transactions, lenders have negotiated lien subordination as a sacred right in connection with a new money financing unless it is offered to all existing lenders pro rata.

Kirpalani: The best protection is to evaluate the risk before it happens and anticipate what the company may do in a downturn. Providing feasible,

attractive financing options to the company is by far the best defence. Unfortunately, lenders that only hold a minority position in the debt may be unable to deliver the required votes. In some cases, such lenders have attempted to acquire a greater position to make a viable proposal. If efforts to provide financing do not bear fruit, and the non-participating lenders feel they have been wronged, it is imperative to commence litigation in a timely manner. Allowing those that participate in a liquidity transaction to control the narrative in court is never a wise decision. If the company winds up in Chapter 11, it is going to be difficult to justify continuing the suit in any other forum, but speaking up early in the Chapter 11 case is critical to ensure the court sees the entire field. The ideal strategy would be to bifurcate or defer intercreditor disputes until after emergence from bankruptcy. This often requires either a sale to a third party or exit financing to be provided from another source.

Vonnegut: In out-of-court transactions, this depends entirely on what the applicable credit documents provide for, and the trend is strongly away from minority protections. The only situations in which I have seen strong minority protections are smaller club rescue financings in which all participants are very sophisticated, the capital provided by minority investors is critically needed, including by the majority investors, and there is an understanding among the group about what types of follow-on liability management transactions will and will not be permitted. In large, syndicated financings, the trend appears to be toward more flexibility for borrowers and majority lenders and less protection for smaller lenders. When these transactions are litigated, whether in or out of bankruptcy, the trend in the case law appears to favour large lenders and borrowers.

"The consensus feeling is that aggressive liability management transactions are now part of the standard playbook."

Michael Handler, King & Spalding

Durrer: The best protection available for minority lenders is often to stomach participating in the newly proposed, dilutive security, rather than suffer dilution or subordination. That said, there are two typical reactions that are otherwise utilised. First,

creditors can commence an action for declaratory judgment, asserting that the new transaction violates the underlying governing documents. While this is an expensive option in terms of legal fees, the publicity of the litigation can also be expensive and distracting to the company and help achieve a settlement. Second, in the event of bankruptcy, participation in an official committee of creditors can accomplish the same result, a vindication of rights, with the resultant litigation cost borne by the creditor body as a whole. Third, legislation to define the rules of the road among various creditor constituencies is always an option, but historically Congress has tended to leave intercreditor issues to resolution by private contract.

CD: Could you highlight any recent cases that demonstrate how contentious creditor battles can become? What insights might be drawn from their outcome?

Kirpalani: The trilogy of what has been termed 'creditor-on-creditor violence' consists of *Serta, Boardriders* and *Trimark.* All three were the subject of intercreditor litigation in non-bankruptcy forums, yet only *Serta* filed for Chapter 11. *Trimark* was resolved consensually following mediation during the state court litigation. In such cases venue is crucial. You have to expect that when a company files for Chapter 11, the bankruptcy court will be the most appropriate place to litigate all disputes arising out of the creation or reinvention of its capital structure. The second takeaway is that what may seem like a non-bankruptcy cause of action is actually the flip side of a bankruptcy right that belongs to the estate. While it is commonly known that fraudulent transfer claims can no longer be pursued by creditors once the transferor files for bankruptcy, the reach of what constitutes an estate claim is very broad. The final takeaway is that litigation over the capital structure has taken paramount importance over litigation over a debtor's valuation.

Vonnegut: *Revlon* was extremely contentious at the outset – secured creditors that did not participate in the 2020 rescue financing still strongly opposed it while also being enmeshed in a heated dispute with Citi, the company was experiencing supply chain disruption and acute liquidity pressures, and unsecured creditors were strongly motivated to pursue litigation as well. From there, a fully consensual plan was achieved in less than 12 months in a freefall case with no time for advance planning, and I think there are a few insights to be drawn from that. First, creditors that step up to help the company are positioned for success. Second, senior creditors must be able and fully prepared to defend their position and litigate to conclusion to achieve a good outcome. Lastly, creative settlement structuring can improve outcomes for all and save

value for creditors that might otherwise be burned in a drawn-out case.

Durrer: In the *Serta* case, pending in the US Bankruptcy Court for the Southern District of Texas, a group of creditors have sought and obtained permission to appeal the Bankruptcy Court's decision directly to the US Court of Appeals for the Fifth Circuit. That case involves the interpretation of whether the issuer's approach of utilising the 'open-market purchase' exception to certain creditor priority and treatment rules complied with the underlying documents and market practice. Historically, bankruptcy cases are settled or resolved at the trial court level. The fact that this case is now at the second level of appeal, only one level removed from the US Supreme Court, is a substantial indication that these issues have become somewhat 'franchise' issues that various debt investors are determined to have the courts resolve.

Handler: *Serta* is a great example. In this case you had minority, non-participating lender lawsuits pending prior to the company's Chapter 11 case, then litigation by the non-participating primed lenders in connection with every Chapter 11 milestone, including DIP financing, approval of disclosure statement and plan confirmation. Now, Citadel, as a non-participating lender, is appealing the bankruptcy court's confirmation decision to the Fifth Circuit. 'Creditor battles' are incredibly expensive to the borrower and ultimately have the potential to foreclose other restructuring options. Tens of millions of dollars of incremental restructuring costs for a less than $1bn company is significant. Furthermore, when you pursue a specific type of liability management transaction that results in a subset of your creditors challenging the transaction, you may be creating some uncertainty to your capital structure and thereby foreclose a potential out-of-court restructuring or the ability to pre-package the Chapter 11 case. Of course, these transactions may be the best and only financing options for the company.

CD: What strategies are being used to resolve bankruptcy-related creditor disputes? How important is some level of compromise to preserving or maximising value?

Handler: The cost of litigation, both directly and indirectly, can drive a settlement. Courts often favour pushing the parties to settle and have used mediation to varying levels of success.

Durrer: Litigation remains the resolution of first order with respect to 'lender-on-lender violence'. Happily, mediation is still a very effective tool as well. Bankruptcy courts are well accustomed to

encouraging parties to use mediation. Of course, whenever novel issues arise, there is a cycle of litigation before parties can accurately predict how and whether a negotiated outcome will result in an acceptable range of solutions. The US Bankruptcy Code turns 45 years old this year. From its core principles, this venerable age lends itself to strong predictability across a range of issues. By contrast, the expansion of private credit, which has fuelled highly leveraged capital structures, grew by half a trillion dollars in just eight years since 2010. The relative youth of such a market will continue to generate new issues, and thus new disputes, before becoming more stable and predictable in terms of litigated outcomes.

“Recent bankruptcies have shown that efforts by non-participating creditors to attack and unwind pre-bankruptcy liability management transactions face real challenges.”

Eli J. Vonnegut,
Davis Polk & Wardwell LLP

Vonnegut: Compromise, when possible and on reasonable terms, can unlock value because even weak litigations can be expensive, in terms of direct litigation cost, but also through the cost of delay in a large complex case. Bankruptcy courts must be and generally are willing to fast track intercreditor disputes so that the merits of the dispute determine settlement rather than simply holdup value. With respect to resolution strategies, the return of in-person settlement talks has been hugely impactful – there really is no replacement for putting all warring parties in a conference centre and forcing them to talk and think through how their differences might be resolved – it yields resolutions that just do not happen with a series of phone calls or Zoom meetings. Skilled, credible mediators like sitting or retired judges can also accelerate settlement talks, pressing the parties on the merits of their positions and helping explore creative structures.

Kirpalani: Time-tested settlement strategies continue to be employed successfully in creditor-on-creditor disputes between the ‘haves’ and ‘have nots’, provided the ‘haves’ are willing. The most obvious is to offer non-participating creditors an opportunity to share in potential upside of a company’s recovery. That can be

creatively structured with the assistance of top financial advisers. The form can be outright equity participation, warrants or the rights to buy equity at a discount to plan valuation. Compromise is most critical to maximising value when the company wishes to avoid potential loan defaults that could jeopardise market confidence or even precipitate a bankruptcy. In such cases, companies can use the flexibility in their loan documents a second time, to re-cut the liquidity transaction and allow others to participate as part of a settlement.

CD: With macroeconomic pressures increasing, to what extent should we expect to see a rising trend of bankruptcy-related creditor disputes in the months and years ahead? How are these battles likely to play out?

Durrer: The current environment of climate change, global instability, rising interest rates and foreboding recession discussions will certainly give rise to continued bankruptcy-related creditor disputes. Such macroeconomic pressures will encourage renewed creativity among professionals and advisers to develop bespoke solutions for stakeholders in the months and years ahead. Since the 1990s, we have experienced so-called 'fallen angels', such as Enron and Worldcom, we have witnessed the dotcom and subprime bubbles burst, and the Great Recession after which world governments rallied to support the global economy. We have witnessed universal support following a global pandemic more recently. This economic climate seems to be a 'normal' recession. We must go back to our tools of old to solve it.

Vonnegut: The only trend is up. Liability management transactions are not going away, they are simply too attractive an option for distressed companies that would otherwise need to restructure in court early, and large sophisticated investors have, for the most part, embraced them, so it is difficult to see where market pressure against them would come from. Opposition to those transactions out of court is interesting – some non-participating lenders will continue to litigate against them because they feel they have to, but the risk of countersuit and the cost of the fight will dissuade others. In court, however, estate funded creditors' committee advisers remove a large obstacle, so we expect to see actual or threatened litigation over these transactions increase. Barring a significant shift, however, the law is on participating senior creditors' side in most cases so junior creditors will face uphill battles.

Kirpalani: It is extremely difficult to predict a spike in bankruptcy filings, but 2023 has certainly been the busiest in years. We expect to see the trend of

intercreditor disputes increasing as parties vie for a seat at the table with their borrowers to recapture their investments. We also expect to see greater jurisprudence devoted to the contours of tortious interference and other non-contractual remedies, as well as greater debate around what conduct constitutes equitable subordination and what causes of action belong to the estate versus creditors for purposes of releases under a plan. Lastly, this breed of litigation is spawning renewed interest in the breadth of power of bankruptcy courts.

Handler: The consensus feeling is that aggressive liability management transactions are now part of the standard playbook. Even if a company decides against pursuing an aggressive liability management transaction, it likely has evaluated potential aggressive options. These battles are likely to continue to be very fact and circumstance specific. I think it is a mistake to extrapolate a specific outcome to a litigation based on a single decision unless the court is bound by a clear precedent from a higher court. CD