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Sunny With Clear Skies, But a Chance of Turbulence on the Horizon: Private Credit Restructuring Year in Review

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This past year was marked by extraordinary deal activity. Record breaking M&A activity drove record breaking private credit activity. Private equity M&A activity was at a substantial high, with over 8,500 deals worth $2.1 trillion, a 60% increase over 2020. Not surprisingly, in this environment, defaults were at all-time lows. The Proskauer Private Credit Default tracker showed an active default rate of approximately 1% at the end of 2021, compared to 3.6% in 2020. This is largely consistent with the syndicated loan market and, thus, no surprise that chapter 11 bankruptcy filings were at a 40-year low.

Nonetheless, private credit lenders still had to address those deals that did require restructuring. The majority of our restructurings were "amend and extends," while some required more extensive attention, including debt-for-equity exchanges, sales, and change of control transactions in both in- and out-of-court deals.

Heading into 2022, private credit activity remains robust. However, the continued unpredictability of COVID, potential interest rate increases, elimination of federal stimulus, stubborn inflation, rising wages, persistent stresses on the supply chain, among other uncertainties, continue to present challenges for many businesses.

We look back at last year's bankruptcy decisions instructive for private credit lenders. These cases involved golden shares, make-whole premiums, third-party releases, and ultra-fast prepacks. There were also a couple of cases that are noteworthy because they serve as reminders that deal structure and strength of documentation can be determinative of key lender rights.

***3P Hightstown*: Golden Share In the Spotlight Again**

A “golden share” refers to an equity interest in a company that affords the holder a number of consent rights, including consent for the company to file a voluntary bankruptcy. Thus, the holder of a golden share has the powerful right to block a company from filing for bankruptcy. The golden share has a checkered history of enforcement because courts struggle with the tension between freedom of contract and the public policy that protects the right to file bankruptcy. In sum, some courts have been more inclined to enforce a golden share that was granted in connection with a true equity investment, and, generally, courts have not enforced a golden share if it was used as a tool for debt collection.

In 2021, the bankruptcy court for the district of New Jersey enforced a golden share. *See In re 3P Hightstown, LLC*, 631 B.R. 205 (Bankr. D.N.J. 2021). In *3P Hightstown*, an investor held debt and preferred equity in the debtor. In connection with the equity issuance, at the time the investor made its equity investment, the debtor modified its LLC agreement (governed by Delaware law) to prohibit a voluntary bankruptcy filing without the preferred shareholder’s consent. The debtor subsequently filed chapter 11 without the required consent, and the investor sought to dismiss the bankruptcy case as an unauthorized filing.

Judge Kaplan first found the LLC agreement’s plain language prohibited the filing because the investor did not consent. The court then considered the public policy arguments relied upon by other courts that refused to enforce such consent rights under similar facts.

In distinguishing those other cases, Judge Kaplan emphasized the bankruptcy consent right granted to the preferred shareholder in connection with a substantial equity investment was not “merely a ruse to ensure” the debtor would repay the debt portion of its investment. *Id*. at 212. This fact distinguished the *3P Hightstown* case from *In re Lexington Hosp. Grp., LLC*, 577 B.R. 676 (Bankr. E.D. Ky. 2017) and *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), where the Kentucky and Delaware bankruptcy courts struck down golden shares held by lenders who conditioned financing or forbearance on receipt of a golden share type equity stake to give the lenders veto power over a bankruptcy filing.

Judge Kaplan also considered the Delaware bankruptcy court's bench decision in *In re Pace Industries, LLC*, 2020 WL 5983650 (Bankr. D. Del. May 5, 2020), which we reviewed previously. *See* [*https://www.proskauer.com/alert/the-golden-share-all-that-glitters-is-not-gold*](https://www.proskauer.com/alert/the-golden-share-all-that-glitters-is-not-gold). In *Pace*, the Delaware bankruptcy court refused to enforce a golden share held by a minority shareholder on the ground, in large part, that the refusal of the minority shareholder to consent to a bankruptcy filing conflicted with the minority shareholders' fiduciary duty to other shareholders and creditors. In our prior alert, we viewed the invalidation of the consent right on the ground of breach of fiduciary duty as a "bridge too far."

Judge Kaplan raised similar concerns expressing "serious reservations" about the notion that non-controlling minority shareholders have fiduciary duties. The court also noted that, in that case, even if such duties exist, the LLC agreement disclaimed any such duties. As a result, Judge Kaplan concluded that the golden share does not violate public policy in *3P Hightstown*.

Takeaway: Private credit lenders can learn three important lessons from this decision. First, the validity of a golden share is almost always litigated. Second, the golden share is more likely to be enforced when issued in connection with a substantial equity infusion and not in the context of a debt restructuring. Finally, the golden share is more likely to be enforced when used to facilitate a value maximizing transaction, rather than as a means to create leverage for a creditor.

***Mallinckrodt*: Make-Whole Premiums**

Make-whole premiums continued to generate litigation. Cases to date have focused on whether the premium is simply unmatured interest (which is unenforceable under the Bankruptcy Code), whether the drafting of the make-whole was ambiguous, or whether the premium is an unenforceable disguised penalty or an enforceable form of liquidated damages. The *Mallinckrodt* case addresses enforceability in a new context—entitlement to a make-whole premium under a debt reinstatement plan.

In *In re Mallinckrodt plc*, Case No. 20-12522 (JTD), the debtor proposed a plan that sought to "reinstate" its first lien debt without paying a make-whole premium that was triggered solely on account of the debtor's chapter 11 filing. To reinstate a debt under the Bankruptcy Code, a Chapter 11 plan must (1) cure *certain* defaults, (2) reinstate the maturity that existed before the default and any resulting acceleration, (3) restore all other pre-default terms of the obligation, (4) compensate the affected creditor for any damages, and (5) leave unaltered the creditor's legal, equitable, and contractual rights. *See* 11 U.S.C. § 1124(2). Reinstatement is relatively uncommon because the entirety of the reinstated debt effectively rides through the bankruptcy case without any changes.

One significant exception to the cure requirement for reinstatement in section 1124(2) is the plan does not have to cure a default "of a kind specified in section 365(b)(2)." Section 365(b)(2), in turn, provides that a debtor does not have to cure defaults triggered by the filing of a bankruptcy case (generally referred to as "ipso facto clauses"). In light of the ipso facto exception, Mallinckrodt argued it did not need to pay the make-whole premium because it was triggered solely by virtue of the filing of the bankruptcy case.

The bankruptcy court agreed. The court held section 1124(2) allows the debtor to "decelerate" the first lien claims and "roll back the clock" to before the default that gave rise to the make-whole premium. While section 1124(2) requires debtors to cure defaults to reinstate debt, it does not require the cure of defaults that arise solely as a result of a chapter 11 filing, such as the make-whole premium in this case. This scenario, the bankruptcy court stated, is precisely the type of situation section 1124(2) of the Bankruptcy Code was intended to address, adding that forcing the debtors to reinstate the premium would impose a "bankruptcy penalty" on the debtors, and confer a "windfall" on the first lien lenders solely by the "happenstance" of the debtors' filing.

Takeaway: The Mallinckrodt decision does not represent a substantial shift in the legal landscape concerning make-whole premiums in the Third Circuit because the decision is limited to make-whole premiums in a reinstatement plan where the payment is triggered solely due to a default caused by the chapter 11 filing.

***Belk*: A Wrinkle for Ultra-Fast Prepacks**

We have written extensively on the “24 hour” prepackaged bankruptcy case and our belief that private credit lenders should expect that trend to continue in the next wave of restructuring activity. *See* *https://www.proskauer.com/pub/restructuring-trend-the-ultrafast-prepack-for-private-credit-deals*.

The recent chapter 11 case of department store chain Belk Inc. serves as the latest illustration of the ultrafast prepack with one, new procedural wrinkle. With only sixteen (16) hours passing between the bankruptcy filing and consummation of a chapter 11 plan that eliminated $450 million of secured debt and procured $335 million of new financing, *Belk* set a record for the fastest prepackaged chapter 11 case to date. The plan had the support of nearly 100% of term loan creditors and all trade debt was unimpaired. And, now, the procedural wrinkle.

To assuage criticism that the ultrafast prepack may not afford all parties in interest whose rights are impacted sufficient due process including a meaningful opportunity to participate at the confirmation hearing, the United States Bankruptcy Court for the Southern District of Texas drafted and entered a “Due Process Preservation Order” that may accompany confirmation of other ultrafast prepackaged plans in the future. Among other things, the Due Process Preservation Order (i) allows parties to opt out of the plan’s third-party releases, which, in any event, now have dubious validity in light of the Purdue Pharma district court opinion, (ii) permits certain creditors to resolve disputes with respect to their claims in court, (iii) limits the plan’s exculpation provisions, and (iv) provides for the post-confirmation filing and resolution of objections to confirmation of the plan, and to the assumption and assignment of contracts and leases. Importantly, the Due Process Preservation Order controls over any conflicting provision in the plan or confirmation order.

Takeaway: The decision should not impede future ultra-fast bankruptcy cases that fully protect the rights of parties not consenting to the plan. Given the attractiveness of the ultrafast prepack as a bankruptcy strategy, private credit lenders should expect more bankruptcy courts to follow the Texas bankruptcy court and enter similar due process orders in future cases. While this procedural wrinkle may invite objections from parties, including hold-up opportunists, after the chapter 11 plan has been confirmed, if the plan is carefully crafted to protect rights of those not consenting, the swift confirmation should be defensible and not subject to material change. Consensual prepacks that pay unsecured creditors in full and do not depend on discharge or restructuring of obligations held by entities not consenting to confirmation should remain viable, albeit with less finality and more risk at the time of confirmation. The Due Process Preservation protects those stakeholders where their rights may be impaired without a seat at the table.

***Murray Energy*: Scope of Required Lenders' Power to Waive Lenders' Rights Starts with What the Credit Agreement Says**

In *In re Murray Energy Holdings Co.*, 2021 WL 3610094 (S.D. Ohio Aug. 13, 2021), an Ohio bankruptcy court denied a request to compel payment of default interest made by GACP, the sole first in, last out lender in a multi-tranche DIP facility. The DIP facility in *Murray Energy* was made up of two tranches: (i) a $90 million first in, last out ("FILO") tranche of rolled up prepetition debt held by GACP; and (ii) a $350 million new money postpetition term loan tranche held by certain of the debtors' pre-bankruptcy term lenders—a group that did not include GACP. The debtor breached a maintenance covenant under the DIP facility, giving GACP the right to accelerate the FILO tranche and to impose a default rate of interest in respect of the FILO tranche, but the new money lenders executed a waiver of the default interest. While the DIP credit agreement provided that GACP has the typical sacred right protection with respect to the reduction of interest, it nonetheless provided that default interest could be waived by Requisite Lenders (which included the new money lenders). GACP argued that since interest could not be reduced without its consent, it could not be waived without its consent.

The bankruptcy court did not think the matter was a close call. Judge Hoffman found that although a reduction of the interest rate would require the consent of each affected lender, "Requisite Lenders" were expressly permitted to waive default interest. While it may appear unfair that the new money lenders could waive default interest owed to GACP, the court focused on the express terms of the DIP credit agreement in denying default interest. Applying New York law as required by the DIP credit agreement, Judge Hoffman observed that "the rule that contractual language must be enforced in accordance with the plain meaning of its terms applies with even greater force in commercial contracts negotiated at arm's length by sophisticated, counseled businesspeople."

Takeaway: At a time when capital structures have become increasingly complex, in the context of a debt restructuring in or out of bankruptcy, lenders and equity sponsors are focused on determining whether certain bargained for contractual rights are truly "sacred." The Murray Energy decision serves as a reminder to private credit lenders that the plain terms of a heavily negotiated credit agreement will be enforced even when the result may seem unfair.

***Town Sports*: Another Lesson on Clear Drafting**

In *In re Town Sports International, LLC*, Case No. 20-12168 (CSS), an ad hoc group of the debtors' prepetition first lien lenders and one of the company's DIP lenders, Tacit Capital LLC ("Tacit"), formed a joint venture (the "Buyer") to acquire the debtors' assets through a credit bidding transaction in which (i) the lenders would capitalize the Buyer by contributing their debt in exchange for $35 million of new term debt from and 20% of the equity in the Buyer; (ii) Tacit would capitalize the Buyer with $47.5 million in cash in exchange for 80% of its equity; and (iii) the Buyer would credit bid $80 million of the lenders' debt in exchange for the debtors' assets. The debtors' sale process began with a bidding procedures order in which the bankruptcy court declared an asset purchase agreement with the Buyer to be the stalking horse bid. Notably, the asset purchase agreement contained an express representation that the transaction had been fully authorized and the Buyer's obligations to consummate the sale were not conditioned upon satisfaction of any financial or other arrangements between the joint partners. Following an additional marketing period, no further bids were submitted, the debtors cancelled the auction and asked the court to approve the Buyer's stalking horse credit bid.

After the bankruptcy court approved the sale, but prior to closing, Tacit backed out of the deal because it was unable to obtain financing for its $47.5 million capital contribution to the Buyer. Instead, Peak Credit LLC took Tacit's place, but it would only provide $5 million in financing and would not cause the Buyer to issue the new debt to the lenders. In light of these developments, the lenders sought to undo their credit bid and requested an injunction to prevent the sale from closing. The debtors and unsecured creditors' committee objected, arguing that the sale had already been approved by the court, the Buyer had represented its unconditional authority to close the sale, and any disputes between the joint partners must be worked out separately.

The bankruptcy court rejected the lenders' arguments, holding that under the asset purchase agreement and the order approving the sale, the lenders had transferred their right to credit bid to the Buyer and had fully authorized the transaction. *See* Case No. 20-12168, Nov. 30, 2020 Hr'g Tr. at 27:3–22. The bankruptcy court also found it would prejudice the debtors and other parties in interest to allow the lenders to block the sale over what the court characterized as a dispute between non-debtors over the capitalization of the Buyer entity. *Id*. at 25:22–26:5. The bankruptcy court denied the requested injunction and directed the Buyer to close. *Id*. at 28:5–14. The dispute continued to a different forum with intra-lender litigation in the Southern District of New York, which remains pending.

Takeaway: Given the increasing number of distressed acquisitions by credit bidding lenders, Town Sports is a cautionary tale about choosing joint venture partners and best practices for documenting a credit bid involving an operating partner. Joint venture acquisitions of distressed companies are common. But where circumstances are such that purchaser capitalization, financing, or operational arrangements cannot be finalized before the execution of a purchase agreement with the seller, then lenders must take care to ensure that (i) the purchaser's representations are carefully and accurately drafted, (ii) the purchaser's obligation to close the sale must be expressly conditioned upon completion of such joint venture arrangements, and (iii) a purchaser must retain the right to terminate its purchase commitments if those arrangements do not come together in time for closing. In the context of Town Sports where no competing bids were made after a marketing period, it is certainly plausible that the court and creditors' committee would have approved the sale even if it were subject to the condition subsequent to funding.

Purdue Pharma: Illegal Releases

Perhaps more than any other decision this past year, the Purdue Pharma decision sent shockwaves through the restructuring world and beyond when the District Court for the Southern District of New York issued a 142-page decision determining that third-party non-consensual releases are unauthorized by the Bankruptcy Code. In other words, a reorganization plan cannot forcibly compel a creditor to release its own claim against non-debtors, typically the company's insiders. The Purdue Pharma case is now before the Second Circuit, and possibly heading to the Supreme Court if not settled pursuant to an ongoing mediation. Despite the attention-grabbing headlines, we do not believe this ruling will disrupt most private credit restructurings outside the mass tort context.

Purdue Pharma's reorganization plan was predicated on an insider settlement. The insiders agreed to contribute approximately $4.3 billion to settle approximately $11 billion of claims against them for their role in managing the company, including alleged fraudulent transfers and improper dividends. These transfers were potentially subject to disgorgement because of the overhang of claims against Purdue Pharma arising from the opioid crisis Purdue Pharma was accused of causing. In exchange for their contribution, the insiders wanted complete finality with respect to all claims against them by Purdue Pharma and by all its creditors. Notably, the settlement did not allocate the $4.3 billion insider payment between Purdue Pharma and creditors. Thus it was possible that the $4.3 billion was less than what they owed Purdue Pharma and they were not contributing anything for claims of other creditors. The reorganization plan was supported by more than 95% of creditors. But a handful of creditors (including the states of California, Washington, and Connecticut) refused to yield. Those creditors argued they could not be forced to release their direct claims against the insiders.

Purdue Pharma, citing Second Circuit precedent and the law of six other circuits, argued that the bankruptcy court had the authority to enjoin a creditor from suing a third-party in unique cases where the injunction is vital to the success of the reorganization plan. The bankruptcy court agreed and confirmed the plan. The objecting states appealed.

The district court disagreed. It vacated the confirmation order and held that the Bankruptcy Code does not permit the granting of nonconsensual third party releases to non-debtors with respect to “direct” claims against the released parties. The court distinguished between direct claims against the controlling insiders arising from their own conduct, and “derivative” claims that would render those insiders liable because of the debtors’ actions, limiting its discussion to nonconsensual third-party releases of direct claims. Because the district court concluded that the Bankruptcy Code does not authorize coerced releases of claims against nondebtors, it did not rule on the issue of whether coerced releases would be unconstitutional even if the Bankruptcy Code did authorize them, such as it does in the context of asbestos cases.

The propriety of nonconsensual third-party releases in a chapter 11 plan has long been controversial, and other courts have taken inconsistent approaches to the issue. Indeed, the Purdue Pharma decision already has led one court to invalidate a chapter 11 plan with broad non-consensual releases of direct claims against third parties. *See Joel Patterson, et al. v. Mahwah Bergen Retail Group, Inc.*, 2022 WL 135398 (E.D. Va. Jan. 13, 2022).

Takeaway: The disputes over the legality of non-consensual third-party releases may not be resolved any time soon. The Third Circuit upheld them in its Millennium decision and may well not revisit its conclusion. Thus, the Supreme Court will likely be the final arbiter, and if the Purdue Pharma case is settled in the pending mediation, we will have to wait for a new case to establish a conflict in the circuits likely to warrant Supreme Court review. Even that review may not end the controversy if it does not deal with both the Bankruptcy Code's purported authorization of coerced releases and their constitutionality. But there is no reason to believe the attack on non-consensual third-party releases will impact releases commonly afforded to private credit lenders in DIP financing orders, which universally include a so-called "challenge period," because creditors can file their claims and are not coerced to grant releases without filing claims. The purpose of a challenge period is simple and powerful: in exchange for providing financing, (1) the debtor and its estate will release any and all claims that the debtor or its bankruptcy estate may have against the lender and (2) all other third parties (e.g., committees, creditors, and shareholders) will have a finite time period (usually 60–75 days) to assert any and all such claims. This period of time is referred to as the "Challenge Period." A claim against the lender is released and barred forever if not brought before the expiration of the Challenge Period. As a result, lenders (at least those that provide DIP financing) do not need to rely on non-consensual third-party releases in plan confirmation orders because of the protection afforded in the DIP order. In the absence of an asserted challenge, the DIP Order will sufficiently release <u>all</u> derivative claims and <u>all</u> challenges to the validity, priority, and allowance of the lenders' claim (including recharacterization and equitable subordination). In the vast majority of cases, this protection is sufficient. Moreover, directors who insist on broad third-party non-consensual releases as a condition to a consensual restructuring risk derailing an arguably value maximizing path in order to advance their own self-interest, and may find themselves as litigation targets facing potential liability for failing to honor their fiduciary duty of loyalty to the company. See Friedman v. Wellspring Capital Mgmt., LLC (In re SportCo Holdings, Inc.), 2021 WL 4823513 (Bankr. D. Del. Oct. 14, 2021) (finding that a claim for breach of duty survived a motion to dismiss against directors who allegedly derailed a viable value maximizing transaction by insisting on personal releases). To be sure, the directors would argue that they would have indemnity claims against the company arising out of creditors' claims against them, and insisting on a release in that circumstance may not be a breach of any fiduciary duty.

Conclusion and a Look Forward

We suspect that 2022 will again be marked by strong deal activity alongside certain macro-level warning signs of potential turbulence ahead. Private credit lenders have proven to be adept at managing troubled situations, and the lessons learned from 2021 can serve to enhance their restructuring strategies if their credit documents are carefully crafted with the lessons in mind.

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