RECENT DECISIONS AND TRENDS IN BANKRUPTCY CASES AND LESSONS FOR TRADE CREDITORS

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THIRD-PARTY RELEASES: RECENT MAJOR CASES

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THIRD-PARTY RELEASES

WHAT ARE THEY

- Power of bankruptcy lies in its ability to discharge a debtor's pre-bankruptcy debts and thereby provide the debtor with a fresh start
- However, bankruptcy has also been used to resolve the liabilities of third parties who share an interest with the debtor (*e.g.*, officers, directors and equity holders)
- This quasi-discharge is effectuated by including provisions in a chapter 11 plan that bar creditors and other interested parties from asserting their direct claims against specified third parties once the plan is confirmed

THIRD-PARTY RELEASES

WHAT ARE THEY

- In most cases, third-party releases are consensual (*e.g.*, where parties must affirmatively opt into the release) or at least deemed consensual (*e.g.*, where parties receive the option to opt out)
- Controversy arises when a plan imposes third-party releases with no ability to opt out
  - In such a case, a party would be precluded from asserting its own claims against the third parties following plan confirmation

THIRD-PARTY RELEASES

WHAT ARE THEY

- Non-consensual third-party releases conflict with the notion that the benefits of bankruptcy are reserved for parties who file bankruptcy and, in doing so, subject themselves to the bankruptcy process and everything it entails
- Accordingly, in some jurisdictions, non-consensual third-party releases are strictly forbidden
- Other jurisdictions permit such releases, but even those courts acknowledge that they represent the exception, not the rule, and are only appropriate in limited circumstances

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (Second Circuit)
  - OxyContin epidemic resulted in huge liabilities against both Purdue Pharma and its owners, the Sackler family
  - In Purdue bankruptcy, Sackler family agreed to contribute $4 billion toward Purdue's bankruptcy estate to help satisfy OxyContin tort claims in exchange for a full release of all claims against them personally
    - Bankruptcy court approved
    - On appeal, District Court reversed, holding that Bankruptcy Code does not permit bankruptcy courts broad authority to impose non-consensual third-party releases in reorganization plans
      - District Court also disagreed with bankruptcy court that Second Circuit precedent permits non-consensual third-party releases

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Sackler family agreed to increase their bankruptcy contribution to $5.5 billion in a revised settlement agreement
  - Second Circuit reversed, approving the third-party release and holding that bankruptcy courts have the authority to impose non-consensual releases of third-party claims in limited circumstances

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Seven factors articulated by Second Circuit for approval of a non-consensual third-party release
    - (1) whether there is an identity of interests between the debtors and related third parties;
    - (2) whether claims against the debtor and third party are intertwined;
    - (3) the scope of the releases;
    - (4) whether the releases are essential to the reorganization's success;
    - (5) the third party's contribution of "substantial assets" to the reorganization;
    - (6) whether the impacted claimholder class(es) "overwhelmingly" support the releases; and
    - (7) whether the plan provides fair payment of the enjoined claims.

THIRD-PARTY RELEASES
RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - The Second Circuit's application of the factors to the Sackler family:
    - (1) because the Sacklers were directors and officers of Purdue, a closely held corporation, there was a sufficient identity of interests between the two parties
    - (2) because the bankruptcy court narrowed the release to only direct claims against the Sacklers, the claims between the parties were "sufficiently intertwined"
    - (3) & (4) Considering the third and fourth factors jointly, the court found that the releases were necessary to the reorganization and proper in scope, because they were essential to ensure that the *res* of the estate was settled and not entirely depleted
      - But the court clarified that if the only reason for including a release is the third party's contribution to the bankruptcy, then the release is not essential to the plan
    - (5) Focusing on the impact of the Sacklers' financial contribution, the Second Circuit concluded that the $5.5 billion pledged by the Sacklers - potentially the largest sum ever contributed to a bankruptcy - was a substantial contribution
    - (6) The personal injury classes "overwhelmingly" approved the plan by over ninety-five percent
    - (7) Although the estimated value of potential claims against the Sacklers surpassed their net worth, the plan provided fair payment of claims—which far exceeded the total funds available, as well as the Sackler's personal wealth

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Bankruptcy Code does not expressly permit third-party releases
  - However, the Second Circuit derived statutory authority to impose such releases from §§ 105(a) and 1123(b)(6) of the Bankruptcy Code
    - Those sections jointly grant bankruptcy courts "residual authority" to modify creditor-debtor relationships by including other provisions in a plan not inconsistent with the Bankruptcy Code
  - The Court further reasoned that because the Bankruptcy Code does not explicitly forbid third-party releases, such releases are not inconsistent with the Bankruptcy Code
    - Therefore, bankruptcy courts have implied equitable authority to impose such releases in chapter 11 plans

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - Recently, the United States Supreme Court reversed the Second Circuit, holding that the Sackler releases could not be approved because the Bankruptcy Code does not authorize releases and injunctions benefiting third parties without the consent of affected claimants
  - Discharge – which is essentially what Purdue Pharma sought for the Sacklers – is only available for "a debtor who places substantially all of their assets on the table." Since the Sacklers did not themselves file for bankruptcy, the discharge they were being provided under the plan was improper

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Purdue Pharma* (the OxyContin manufacturer) (cont'd.)
  - The Supreme Court was careful to state, however, that a plan containing *consensual* third-party releases is proper, without going into detail as to what "consensual" means
  - This decision effectively provides the death blow for non-consensual plan releases in favor of third parties

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Ascena Retail Group* (E.D. Va.)
  - Retailer of apparel for women and girls with brands such as Ann Taylor, LOFT, Lane Bryant and Lou & Grey
  - Ascena bankruptcy Plan included broad third-party releases covering any type of claim that existed or could have been brought against any person or entity associated with the debtors as of the effective date of the Ascena Plan, including a securities fraud class action lawsuit then pending against certain prepetition executives of Ascena
  - The releases bound anyone that did not affirmatively "opt out" of such releases in a plan ballot
    - Because creditors had the ability to opt out of the third-party releases in connection with their plan ballot, the Bankruptcy Court treated the releases as "consensual“
    - Following confirmation, the United States Trustee and the securities fraud litigation plaintiffs appealed the bankruptcy court's decision to the District Court

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Ascena Retail Group* (E.D. Va.) (cont'd.)
  - On appeal, District Court found that:
    - Bankruptcy Court did not have jurisdiction to approve the third-party releases
    - The releases were <u>not</u> consensual, noting that the Bankruptcy Court did not consider the proper threshold question in determining whether the releases were consensual
      - Bankruptcy Court looked only to whether a releasing party had returned the required "Release Opt-Out Form" (if not, the release would automatically be deemed consensual)
        - » District Court rejected that approach, holding that the Bankruptcy Code requires an overt act—such as affirmatively "opting in" to the release—evidencing the party's consent to resolve the claim
        - » Inaction in the form of failing to opt out of a release was insufficient given the constitutional standard for active, knowing and voluntary consent.
  - Ascena filed and received approval of a revised Plan that did not include the third-party releases

THIRD-PARTY RELEASES

RECENT DECISIONS

- *Mallinckrodt* and *Boy Scouts of America* (Bankr. D. Del.)
  - Third-party releases are expressly permitted in the Third Circuit
  - In two different cases in the Delaware bankruptcy court in 2022, Delaware bankruptcy judges found that
    - Third Circuit precedent expressly allows non-consensual third-party releases
    - Opt-out provisions make a release consensual

THIRD-PARTY RELEASES

RECENT DECISIONS

- In *Mallinckrodt*, the Bankruptcy Court found that
  - Under precedent in the Third Circuit (which covers Delaware), the Bankruptcy Court had the requisite authority to approve the non-consensual opioid releases
  - The Bankruptcy Court possessed constitutional authority because these releases were integral to the success of the debtors' plan
  - Without the releases, settlements that were essential to the plan would not be effectuated and, without the settlements, the plan would fall apart
  - In contrast to *Ascena*, the opt-out provisions of the third-party releases rendered them consensual
    - In making this determination, the Bankruptcy Court examined the extent of the notice given and found ample evidence in the record that the debtors made every effort to ensure that the releasing parties were sent notices in a variety of ways that clearly explained in "no uncertain terms" that action was required to preserve claims

THIRD-PARTY RELEASES

RECENT DECISIONS

- In *Boy Scouts of America*, the Bankruptcy Court
  - Agreed with the *Mallinckrodt* decision that:
    - Opt-out provisions make a non-consensual release consensual
    - Non-consensual releases fall within the Bankruptcy Court’s constitutional authority where the release is “integral to the debtor-creditor relationship”

THE "TEXAS TWO-STEP:" RECENT DECISIONS

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TEXAS TWO-STEP

WHAT IS IT

- Companies facing multidistrict litigation mass tort exposure have been utilizing a new technique to protect themselves and their related entities from mass tort claims
- Known as the Texas Two-Step, this creative use of the Bankruptcy Code gives related entities the benefit of the automatic stay without those companies having to file for Chapter 11 bankruptcy protection themselves

TEXAS TWO-STEP

WHAT IS IT

- In the Texas Two-Step, a defendant corporation will assign its liabilities to a newly-formed subsidiary under Texas law, which allows this type of divisive merger under its business corporations statute
- The subsidiary with the liabilities will then file bankruptcy, which stays the lawsuits, and seek to extend the automatic stay to its affiliated entities with the goal of resolving all MDL through the bankruptcy system
- Doing so allows companies to utilize the bankruptcy system's expedited timeline and avoid defending claims case-by-case

TEXAS TWO-STEP

WHAT IS IT

- Non-debtors seek to obtain the benefit of the automatic stay by entering into funding agreements through a Chapter 11 reorganization plan, which provides funds to be administered by a trust for the benefit of the debtor’s tort claimants
- Debtors can then argue they need to protect non-debtors because there will be sufficient assets to pay tort claimants
- Debtors also argue that allowing the litigation to proceed against these non-debtors would distract the debtor from its reorganization efforts
- These creative efforts by debtors to protect their affiliates are controversial since the non-debtor affiliates obtain the automatic stay protections without having to file for Chapter 11
- Thus, nondebtor affiliates avoid the fiduciary responsibilities of Chapter 11 and do not have to disclose their assets and liabilities, permit investigations by creditors, or provide transparency of their business operations as normally required under the Bankruptcy Code

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (Bankr. D.N.J.)
  - Some consumers of Johnson & Johnson baby powder alleged that they were diagnosed with cancer caused by talc, one of the powder's ingredients
  - J&J faces over 38,000 lawsuits alleging ovarian cancer and mesothelioma caused by exposure to talc
  - After many years of litigation and mixed verdicts, J&J turned to the New Jersey bankruptcy court for relief — not for itself, but for its affiliated entity, LTL

TEXAS TWO-STEP

RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - In 2021, J&J formed two subsidiaries
    - It moved its assets into one entity and transferred certain assets and its talc liabilities into the other, LTL
  - Shortly thereafter, LTL filed bankruptcy, which stayed the pending talc cases against LTL, but not against J&J and its other non-debtor affiliates
  - J&J and LTL then established a funding agreement for talc claim liabilities as part of the bankruptcy process
  - The Talc Claimants Committee sought dismissal of the bankruptcy petition for bad faith
  - In 2022, the Bankruptcy Court denied the motion to dismiss the LTL bankruptcy case, holding that the proceeding would address the talc claims and that LTL was in financial distress and not seeking to restructure to secure a tactical advantage
    - LTL's request for continued injunctive relief was also granted

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - Talc Claimants Committee appealed
    - Third Circuit reversed and found that LTL did not file its bankruptcy petition in good faith as LTL was not in financial distress and had the benefit of the J&J funding agreement
      - This holding would have allowed the talc claimants to continue to pursue their claims through the tort system against LTL, J&J, and their related entities
    - Third Circuit directed Bankruptcy Court to dismiss the bankruptcy case

TEXAS TWO-STEP

RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - Within hours of the bankruptcy court's dismissal order, LTL filed for Chapter 11 protection a second time
    - This time, J&J also agreed to contribute $8.9 billion to establish a funding agreement to resolve all current and future talc claims
  - Second LTL bankruptcy dismissed
    - New Jersey bankruptcy court found that LTL could not show sufficient financial distress to warrant bankruptcy protection, given the hundreds of billions in assets and annual financial revenue of parent company J&J

TEXAS TWO-STEP
RECENT DECISIONS

- *LTL Management* (Johnson & Johnson talc liability case) (cont'd.)
  - LTL is now contemplating a *third* bankruptcy filing. It is actively negotiating with plaintiffs regarding a new chapter 11 plan with a $6.48 billion settlement fund
  - Further, LTL has moved to Texas, hoping that the courts there will be more hospitable to its third attempt at bankruptcy through the Texas Two-Step

TEXAS TWO-STEP

RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (Bankr. S.D. Ind.)
  - In 2008, 3M Co., a multinational conglomerate that manufactures industrial, safety and consumer products, acquired Aearo Technologies, a designer and manufacturer of personal protection and energy-absorbing products
  - In July 2022, Aearo filed for Chapter 11 protection in the Southern District of Indiana bankruptcy court
    - 3M placed its subsidiary into bankruptcy after it spent over $300 million in legal fees defending personal injury lawsuits involving allegedly faulty earplugs that Aearo sold to the U.S. military

TEXAS TWO-STEP

RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (cont'd.)
  - Before filing for bankruptcy, 3M earmarked more than $1 billion under a funding agreement to pay for the claims
  - Aearo's bankruptcy filing automatically stayed the personal injury lawsuits filed against Aearo, but not against 3M, and Aearo requested that the bankruptcy court extend the automatic stay to those claims
    - In August 2022, the bankruptcy court denied Aearo's request to extend the automatic stay and grant injunctive relief to 3M, forcing 3M to continue to defend itself in the personal injury litigations
    - Aearo immediately appealed

TEXAS TWO-STEP

RECENT DECISIONS

- *Aearo Technologies* (3M earplug case) (cont'd.)
  - Invoking the Third Circuit's dismissal of the LTL case, the Tort Claimants Committee in the Aearo case and over 200,000 claimants, veterans, active-duty service members, civilian contractors and consumers jointly moved to dismiss the Aearo bankruptcy cases
    - They argued that, like in LTL, the Aearo debtors were not in any financial distress when they sought bankruptcy protection and that Aearo's current and future tort liabilities to claimants were fully backstopped by 3M under a funding agreement, obviating any need for reorganization
    - On June 9, the bankruptcy court dismissed Aearo's bankruptcy filing
      - Citing LTL, the bankruptcy court held that Aearo was financially healthy and possessed a "greater deal of financial security than warrants bankruptcy protection"
      - The bankruptcy court found no evidence that the impending MDL had, or will have, any substantial effect on Aearo financially

TEXAS TWO-STEP

A LEGISLATIVE FIX?

- There are active efforts by Congress to put an end to Texas two-step bankruptcies
- In July 2024, a bipartisan bill was introduced in the U.S. Senate, the "Ending Corporate Bankruptcy Abuse Act of 2024," that would, among other things, preclude bankruptcy courts from entering injunctive relief that would prevent lawsuits from proceeding against non-bankrupt affiliates of a Texas two-step debtor
  - In other words, this bill would put a stop to exactly what the Texas two-step is designed to achieve
- The act has been referred to the Judicial Committee of the Senate for deliberations

THE TOYS 'R' US DEBACLE: LESSONS LEARNED

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SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

CASH IN ADVANCE IS BEST ALTERNATIVE

- Questions often arise regarding the best way to protect post-bankruptcy shipments
- Cash in advance / COD is best
  - Give us the cash, we'll give you the goods
  - No risk
    - ***<u>Proactive Pointer</u>:*** If switching to cash in advance, make sure to get paid <u>by wire</u>, <u>not by check</u>. Payment by check still presents risk due to possibility of dishonored check after goods are shipped.

SHIPPING TO YOUR CUSTOMER POST-BANKRUPTCY

WHAT IF CUSTOMER WILL NOT PAY CASH IN ADVANCE?

- In some cases, the customer – rather than the vendor – has the leverage and will refuse to pay cash in advance
  - The conundrum
    - We place a large volume of goods with this customer and do not want to lose the revenue
    - At the same time, we want to maximize the likelihood of collection
- That was <u>exactly</u> the situation in *Toys 'R' Us*
- Toys 'R' Us would only buy on terms that existed pre-bankruptcy
  - For most vendors, that was net 60, or even as high as net 90
    - HUGE RISK FOR VENDORS IF TOYS 'R' US BANKRUPTCY FAILS!
      - Administrative insolvency problem

THE TOYS 'R' US DEBACLE

THE DILEMMA – TO SHIP OR NOT TO SHIP

- For most vendors, Toys 'R' Us represented a huge portion of their annual revenue
  - For many vendors, sales to Toys 'R' Us was 33% or more of their annual revenue
    - The dilemma
      - Stop shipping because Toys 'R' Us insisted on cash
        - » But 33% of your revenue falls off a cliff
      - Ship on terms
        - » But risk non-collection if Toys 'R' Us reorganization fails

THE TOYS 'R' US DEBACLE

SHIPPING ON TERMS

- While some vendors chose not to ship at all rather than take the risk of shipping on terms, many vendors couldn't risk losing the revenue and decided to ship
- Toys 'R' Us procurement team had conversations with many vendors that gave them false comfort and induced those vendors to ship

THE TOYS 'R' US DEBACLE
CRITICAL VENDOR STATUS

- Many vendors were offered and took critical vendor status as an apparent means to protect those vendors from potential losses for post-bankruptcy shipments and to induce continued shipments
  - Required vendors to continue to ship goods on lengthy payment terms that existed pre-bankruptcy
  - Critical vendor money was to be paid in installments and on a deferred basis

THE TOYS ‘R’ US DEBACLE

WHAT HAPPENED???

- The story of what happened next……

[MORE] CRITICAL VENDOR CONSIDERATIONS

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CRITICAL VENDOR TREATMENT

- Provides trade vendors priority payment of prepetition claim, usually in full and immediately rather than at end of bankruptcy case
- If you can leverage your way into becoming a critical vendor, the result can be a much better recovery in the bankruptcy
  - Swaps a prepetition, general unsecured claim for, at worst, a postpetition administrative claim

CRITICAL VENDOR TREATMENT

PROS

- May get some or all of your prepetition invoices paid in full
- Preserves ongoing business relationship with debtor
- Likely indicator that your relationship will survive sale of assets and potentially have contract assumed by acquirer of assets
- Possible preference waiver (but see subsequent slides)

CRITICAL VENDOR TREATMENT

CONS

- Typically requires execution of a critical vendor/essential supplier contract
- Typically have to extend credit terms
- May be subject to potential claw-back if debtor thinks you “misbehave”

CRITICAL VENDOR TREATMENT

DOES IT INSULATE CREDITOR FROM PREFERENCE LIABILITY?

- Might not insulate from preference liability absent "something more"
  - *See Insys Liquidation Trust v. McKesson Corp.*, Case No. 21-50176 (Bankr. D. Del. July 21, 2021)
    - Delaware bankruptcy court ruled that critical vendor status does not automatically insulate creditor from preference exposure, absent "something more," where
      - creditor was not specifically named in critical vendor order;
      - Debtor was given discretion, but not required, to make critical vendor payments; and
      - critical vendor order expressly stated that it did not constitute "a waiver of any claims or causes of action that may exist against any creditor."

CRITICAL VENDOR TREATMENT

DOES IT INSULATE CREDITOR FROM PREFERENCE LIABILITY?

- Under *Insys*, "something more" to help insulate creditor from preference exposure could be language in the critical vendor order that
  - requires (i.e., not discretionary) the debtor to pay the creditor's entire pre-bankruptcy balance in full;
  - expressly names the creditor; and/or
  - expressly provides for a waiver of any subsequent preference claims against the creditor
- Express waiver language likely is the best approach
- But……might not be easy to get Debtor to include any of these provisions in critical vendor order, or creditor might not have a seat at the table before critical vendor order is entered, in which case
  - Might need to deal with preference lawsuit later, even after being paid in full as a critical vendor

CONSIGNMENTS: HOW DOING THEM WRONG CAUSED *THE SPORTS AUTHORITY* DEBACLE

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CONSIGNMENTS

- In a consignment arrangement, seller retains ownership of goods
- Consigned goods are delivered to “consignee”
- When consignee sells goods, consignee remits a percentage of sale proceeds to seller and retains remainder
- Seller-consignor does not get paid up front as in a true sale, but offers a measure of protection when buyer-consignee experiences financial difficulty

CONSIGNMENTS

- Consignment treated the same as a purchase money security interest
- UCC § 9-103(d)
  - The security interest of a consignor in goods that are the subject of a consignment is a purchase-money security interest in inventory.
- This means that, if done properly, a seller-consignor has rights that are superior to buyer-consignee's secured lender

CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Two required steps to properly document a consignment of inventory:
  - Must file a UCC-1 financing statement (same as a secured creditor)
    - Check the consignment box to indicate a consignment rather than a security interest
  - Must send notice to other secured creditors
    - Lien search must be done to determine existing secured creditors with a lien on inventory entitled to notice
    - Send notice to all secured creditors with a lien on inventory

CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Timing
  - Both financing statement **and** notices to secured creditors **must be sent before any consigned goods are delivered**
  - Failure to do so will result in consignor's rights in any goods delivered before both of these steps are taken being subordinate to secured lender with lien on inventory

CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Requirement to file a financing statement is found in UCC § 9-317(e)
  - ….[I]f a person files a financing statement with respect to a purchase-money security interest before or within 20 days after the debtor receives delivery of the collateral, the security interest takes priority over the rights of a buyer, lessee, or lien creditor which arise between the time the security interest attaches and the time of filing.
- But for inventory, disregard the idea to file within 20 days <u>after</u> delivery of the goods

CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Notice requirement and timing requirement to perfect (i.e., file financing statement) <u>before</u> delivery of consigned <u>inventory</u> is found in UCC § 9-324(b)
  - ….[A] perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory…and [] also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:

    (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;

    (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;

    (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

    (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

CONSIGNMENTS

RIGHTS OF CONSIGNOR

- A true consignment arrangement that is properly documented prevents security interest of consignee’s secured lender from attaching to consignor’s inventory

CONSIGNMENTS

TRAPS FOR THE UNWARY

- The *Sports Authority* example
  - Approximately 160 consignment vendors
    - Only approximately 40 of those filed financing statements and sent required notice to secured creditors
    - Of those 40, only <u>three</u> filed financing statements sooner than 90 days before Sports Authority filed bankruptcy
      - Those filed within 90 days before bankruptcy were avoidable as preferences, leaving those consignment vendors in the same position as those who did not file financing statements at all

CONSIGNMENTS

TRAPS FOR THE UNWARY

- Lessons from *Sports Authority*
  - Make sure to file a financing statement and send notice of consignment arrangement to secured creditors
    - Make sure to do this <u>before</u> shipping any consigned goods
      - Failure to do so in Sports Authority resulted in
        - » Secured lenders' liens attaching to consigned goods
        - » Secured lenders having priority over consignors
        - » All but the three consignors who properly documented and perfected their consignment arrangements receiving far less than they would have if done properly

SUBCHAPTER V BANKRUPTCY: HIGHLIGHTS OF HOW IT WORKS, RECENT DECISIONS, AND ITS NEGATIVE IMPACT ON CREDITORS

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SMALL BUSINESS REORGANIZATION ACT

SUMMARY

- Small Business Reorganization Act of 2019 ("SBRA") added new Subchapter V to the Bankruptcy Code
- New Subchapter V is
  - Still part of Chapter 11
  - Generally a Chapter 11 filing, but with modifications
    - Modifications are intended to streamline the process
      - More efficient for the debtor
      - Less expensive for the debtor
    - But strips away certain elements of a traditional Chapter 11 that are beneficial to creditors

SMALL BUSINESS REORGANIZATION ACT

SUMMARY

- SBRA adds new Subchapter V to Bankruptcy Code
  - Effective for all cases filed after February 19, 2020
  - For small business debtors
    - Debtor's aggregate, noncontingent, liquidated, secured and unsecured debt cannot exceed $3,024,725
      - When SBRA became law, Subchapter V threshold was originally $2,725,625
      - CARES Act increased eligibility threshold to $7,500,000
        - » March 27, 2021 sunset, at which time eligibility threshold would revert back to $2,725,625
        - » COVID-19 Bankruptcy Relief Extension Act signed into law on March 27, 2021 extends increased $7,500,000 threshold for another year, through March 27, 2022
        - » Extended again in 2022 for another two years
          - » Expectation was that increased threshold would become permanent
            - » Legislation had been pending in Congress that would have extend the higher threshold until 2026
            - » However, Congress failed to act, and on June 21, 2024, the higher threshold sunset automatically and reverted back to $3,024,725 – this is the current debt threshold for Subchapter V

SMALL BUSINESS REORGANIZATION ACT
ELIGIBILITY

- Generally, a "small business debtor" is a business entity or individual
  - "engaged in commercial or business activities"
  - with noncontingent, liquidated debts of not more than $3,024,725
    - at least 50% of which is business debt
  - Bankruptcy Code excludes certain debtors from the small business designation, including
    - any debtor whose primary business is owning single asset real estate
    - any member of a group of affiliated debtors that has aggregate debts in excess of the debt limit
    - any corporate debtor subject to the reporting requirements of the Securities Exchange Act of 1934 (SEA)
    - any debtor that is affiliated with an "issuer," as defined in the SEA

SUBCHAPTER V BANKRUPCY

KEY MODIFICATIONS FROM CONVENTIONAL CHAPTER 11

- Modified plan confirmation standards that greatly benefit small business debtors
  - In order to confirm a subchapter V plan, a debtor must only pay unsecured creditors all "projected disposable income" over a three-to-five year period
    - "Disposable Income" is defined under the Code as "income that is received by the debtor and that is not reasonably necessary to be expended . . . for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor." 11 U.S.C. § 1191(d)
    - Disposable income is reflected on projections that debtor attaches to plan
    - Creates a misincentive for debtors to manipulate disposable income
      - Without meaningful oversight because there is no creditors' committee in a subchapter V case
    - If debtor beats projections post-confirmation, debtor keeps the upside, not creditors!

SUBCHAPTER V BANKRUPTCY

ELIGIBILITY ISSUES

- *In re Offer Space, LLC*, No. 20-27480, 2021 WL 1582625 (Bankr. D. Utah Apr. 22, 2021)
  - Rejecting argument that section 1182 requires the debtor to be engaged in business operations and finding debtor was eligible because business activities does not mean business operations, and the debtor was engaged in business activities including, without limitation, (1) having active bank accounts; (2) having accounts receivable; (3) analyzing and exploring counterclaims in a lawsuit; (4) managing its stock; and (5) winding down its business and taking reasonable steps to pay its creditors and realize value for its assets

SUBCHAPTER V BANKRUPTCY

ELIGIBILITY ISSUES

- *Regus* example
  - Court denied Subchapter V status where many affiliated single purpose LLCs filed separate cases
    - Each individually was under debt limit
    - But all operated together as a single integrated business operation

SUBCHAPTER V BANKRUPTCY

ELIGIBILITY ISSUES

- *In re Free Speech Systems LLC*, Case No. 22-60043 (Bankr. S.D. Tex. March 31, 2023)
  - Debtor Free Speech Systems LLC (owned by the notorious conspiracy theorist Alex Jones) filed subchapter V bankruptcy in July 2022
  - After huge judgment was entered against Jones in October 2022, Jones personally filed a “regular” chapter 11 in December 2022
  - Plaintiffs in the underlying lawsuit filed a motion in the Free Speech Systems subchapter V bankruptcy to revoke its subchapter V status and to have it proceed as a “regular” chapter 11
    - Plaintiffs conceded that Free Speech Systems had less than $7.5 million in debt and was eligible for subchapter V at the time it filed
    - But plaintiffs contended that Free Speech Systems lost its subchapter V eligibility when Jones filed his own chapter 11 bankruptcy because Free Speech Systems and Jones are “affiliates” with aggregate debt in excess of the $7.5 million threshold

SUBCHAPTER V BANKRUPTCY

ELIGIBILITY ISSUES

- *In re Free Speech Systems LLC*, Case No. 22-60043 (Bankr. S.D. Tex. March 31, 2023) (cont'd.)
  - Judge ruled that debtor's eligibility for subchapter V is determined <u>as of the filing date</u>
    - Debtor cannot be kicked out of subchapter V if an affiliate with too much debt for Subchapter V later files a petition under "regular" chapter 11
  - If adopted broadly, this opinion means that a family of companies with too much collective debt for subchapter V may first put one member with less than $7.5 million into subchapter V and later put other companies into "regular" chapter 11 if there is too much debt
    - The first-filing company could then enjoy a simplified route to plan confirmation under subchapter V, while the other members of the group would face the rigors of "regular" chapter 11

SUBCHAPTER V BANKRUPTCY

ELIGIBILITY ISSUES

- *In re Free Speech Systems LLC*, Case No. 22-60043 (Bankr. S.D. Tex. March 31, 2023) (cont'd.)
  - Recently, the FSS case was dismissed, and the Alex Jones case was converted to chapter 7. The dismissal was not related to Subchapter V eligibility, but rather, was ordered as an alternative to conversion in order to allow creditors to pursue their judgments in state court
  - Alex Jones' chapter 7 trustee is actively pursuing efforts to liquidate the remaining assets of FSS, including the INFOWARS media platform

SUBCHAPTER V BANKRUPTCY

DISCHARGE ISSUES

- *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC),* 36 F.4th 509 (4th Cir. June 7, 2022)
  – Corporate debtors in subchapter V are not automatically entitled to a discharge of debts and may be subject to a nondischargeability complaint under § 523(a) of the Bankruptcy Code
- *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022)
  – Disagreeing with *Cleary*, held that subchapter V corporate debtors <u>are</u> entitled to a discharge of debts and <u>cannot</u> be subject to a § 523(a) nondischargeability lawsuit
  – Currently on appeal to the Fifth Circuit

SUBCHAPTER V BANKRUPTCY

DISCHARGE ISSUES

- In addition to the *GFS* case, the four other bankruptcy courts and one Bankruptcy Appellate Panel that have addressed the issue of whether a corporate debtor receives a discharge in a subchapter V have unanimously agreed that it does
  - *Jennings v. Lapeer Aviation, Inc. (In re Lapeer Aviation, Inc.),* Adv. No. 22-03002, 2022 WL 1110072 (Bankr. E.D. Mich. Apr. 13, 2022)
  - *Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications LLC)*, 635 B.R. 559 (Bankr. D. Idaho 2021)
  - *Gaske v. Satellite Rest., Inc. Crabcake Factory USA (In re Satellite Rest., Inc. Crabcake Factory USA)*, 626 B.R. 871 (Bankr. D. Md. 2021)
  - *Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC),* Case No. 23-1020 (9th Cir. (BAP) July 6, 2023)
  - *Cantwell-Cleary Co., Inc. v. Cleary Packaging (In re Cleary Packaging, LLC)*, 630 B.R. 466 (Bankr. D. Md. 2021), *rev'd*. 36 F. 4th 509 (4th Cir. 2022)
    - But reversed on appeal by the Fourth Circuit (see prior slide)
- In all of these cases, the bankruptcy court dismissed a § 523(a) nondischargeability lawsuit filed by a creditor on the basis that § 523(a) does not apply to a corporate debtor in a subchapter V bankruptcy

SUBCHAPTER V BANKRUPTCY

"FAIR AND EQUITABLE" TREATMENT

- *In re Pearl Resources, LLC*, 622 B.R. 236 (Bankr. S.D. Tex. 2020)
  - Creditors objected to proposed Subchapter V plan because it "provides absolutely no specifics on the anticipated amount of Disposable Income, the dates when Disposable Income will be available, or even how Debtors will calculate or report Disposable Income."
  - Court nonetheless confirmed the plan, giving great weight to uncontroverted testimony of debtor's managing member that it is reasonably likely that the debtors will generate sufficient income to pay claims in full within two years
    - And if that fails, debtor has sufficient assets that it can sell to pay claims in full

SUBCHAPTER V BANKRUPTCY

“FAIR AND EQUITABLE” TREATMENT

- *In re Ellingsworth Residential Community Association*, No. 6:20-bk-01346, 2020 Bankr. LEXIS 2897 (Bankr. M.D. Fla. Oct. 16, 2020)
  - Court found that proposed plan was fair and equitable based on testimony of debtor’s president that debtor, a homeowner’s association, could obtain $300,000 to pay into the plan via a special assessment to be approved by debtor’s members
  - Court, however, also required debtor to obtain members’ approval of the assessment within a “reasonable time” after plan confirmation, absent which debtor would be in default under the plan

SUBCHAPTER V BANKRUPTCY

DISTRIBUTION OF DISPOSABLE VS. ACTUAL INCOME

- *In re Hamilton Staples*, 2023 WL 119431 (M.D. Fla. January 6, 2023)
  - In a recent noteworthy decision, a bankruptcy court confirmed a subchapter V plan in which the debtor was required to pay creditors the greater of projected disposable income or actual disposable income per quarter

SUBCHAPTER V BANKRUPTCY

RETROACTIVE SUBCHAPTER V ELECTION

- *In re Progressive Solutions, Inc.*, 615 B.R. 894 (Bankr. C.D. Cal. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V after the case had been pending approximately 15 months
- *In re Glass Contractors, Inc.*, No. 20-40185 (Bankr. E.D. Tex. February 25, 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V after the case had been pending approximately one month

SUBCHAPTER V BANKRUPTCY

RETROACTIVE SUBCHAPTER V ELECTION

- *In re Double H Transp. LLC*, No. 19-31830-HCM, 2020 WL 2549850 (Bankr. W.D. Tex. March 5, 2020)
  - Chapter 11 debtor could <u>not</u> retroactively proceed under Subchapter V when the case had been pending more than three months
- *In re Body Transit, Inc*., 613 B.R. 400 (Bankr. E.D. Pa. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V when the case had been pending 48 days

SUBCHAPTER V BANKRUPTCY

RETROACTIVE SUBCHAPTER V ELECTION

- *In re Bello*, 613 B.R. 894 (Bankr. E.D. Mich. 2020)
  - Chapter 13 debtor in converted case could retroactively proceed under Subchapter V when the converted case had been pending approximately two months
- *In re Ventura*, No. 8-18-77193-REG, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020)
  - Chapter 11 debtor could retroactively proceed under Subchapter V even though creditor's plan of reorganization was scheduled for hearing on confirmation and case had been pending approximately 15 months

SUBCHAPTER V BANKRUPTCY

RETROACTIVE SUBCHAPTER V ELECTION

- *In re Seven Stars on the Hudson Corp.*, 618 B.R. 333 (Bankr. S.D. Fla. 2020)
  - Retroactive Subchapter V election is not permissible if debtor cannot comply with 90-day deadline for filing plan
- *In re Easter*, 623 B.R. 294, 296 (N.D. Miss. 2020)
  - Small business designated Chapter 11 debtor could retroactively proceed under Subchapter V when the case had been pending 10 months and debtor was unable to confirm a plan

SUBCHAPTER V BANKRUPTCY

CASE STUDY

- DISCUSSION OF SPECIFIC CASE EXAMPLE AND ISSUES THAT AROSE
  - *In re Classic Refrigeration SoCal, Inc.*
    - Case No. 8:22-bk-11239-TA (Bankr. C.D. Cal.)
      - Threshold considerations – eligibility for subchapter V
      - Disposable income
        - » Management bonuses
        - » Executive compensation increases
      - Plan term

QUESTIONS

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