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#85 · Autumn 2021

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Chapter 11 under fire: U.S. Congress seeks to end forum shopping

David H. Conaway reports on the recent testimony by Professor Adam Levitin which brings to light new abuses of the Chapter 11 system



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Since its beginning in 1978, Chapter 11 has been the primary tool for financially distressed U.S. and foreign companies to efficiently restructure their balance sheets and business operations.

Successful Chapter 11 cases have allowed prominent financially distressed companies to reorganize or pursue going concern asset sales, adding economic value to the global economy. This includes Lehman Brothers, General Motors, Enron, MF Global, Chrysler, Texaco, US Steel, American Airlines, Delta, United, and the list goes on.

Chapter 11 has become an integral part of the U.S. and global economy and become highly regarded and often a guide for other countries' insolvency laws.

Despite its "success" as a strategic business tool, Chapter 11 has come under scrutiny lately as corrupted by intense "judge shopping". Since its inception, a significant number of Chapter 11 cases, especially mega cases, have been filed in the federal Southern District of New York (SDNY) and Delaware, given those jurisdictions' respective "financial center" expertise and the corporate domicile for corporations. Recently Texas, particularly Houston, has also become a Chapter 11 "hotspot" as well.

On 28 July 2021, Georgetown Law School Professor Adam Levitin testified before the Committee on the Judiciary Subcommittee on Antitrust, Commercial, and Administrative Law United States House of Representatives. The topic was: "Oversight of the Bankruptcy Code, Part I: Confronting Abuses of the

Chapter 11 System."

Professor Levitin notes that 57% of large public company Chapter 11 cases in 2020 were heard by 3 out of 375 U.S. bankruptcy judges, Judge Robert Drain of the Southern District of New York (SDNY), and Judges David Jones and Marvin Isgur both of the Southern District of Texas. Judge Jones presided over 39% of all U.S. mega cases in 2020. In fact, Shumaker has been involved in several significant Chapter 11 cases in 2020/2021 in the Southern District of Texas, including Neiman Marcus, McDermott International (Chicago Bridge & Iron), Technicolor and Dean Foods (25+ household name dairy brands). In essence, Professor Levitin's thesis is that judge shopping has allowed debtors to game the system to the disadvantage of the Chapter 11 process and creditors.

Judge shopping is clearly intentional, based upon case assignment procedures in various bankruptcy courts. In the SDNY, there are eight judges in Manhattan and one in White Plains, Judge Robert Drain, who presided over the Purdue Pharma (manufacturer of OxyContin, a highly addictive opioid) Chapter 11 case. Purdue Pharma did not file Chapter 11 in Connecticut where it is headquartered, or in Delaware where it is incorporated. Rather, Purdue Pharma changed its service of process address to be assigned to the White Plains division of the SDNY. Why did Purdue Pharma want Judge Drain as its judge? According to Professor Levitin's testimony, it is because of the belief that Judge Drain would be inclined to approve a Plan of Reorganization that included broad

releases imposed on creditors of non-debtor related parties, including the Sackler family who controlled Purdue Pharma.

Professor Levitin's written testimony included the following excerpts about the Purdue Pharma case:

Purdue is a closely held company owned by the immensely wealthy Sackler family, whose names grace major museums. The Sacklers functioned, according to the Department of Justice, as Purdue's "de facto CEO." The Sacklers also received as much as \$13 billion in dividends and other payments from Purdue over the years, including after Purdue's contribution to the opioid crisis became clear.

Purdue has proposed funding its plan primarily through a \$4.275 billion contribution from the Sackler family, to be paid out over ten years. The Sacklers agreed to this contribution in exchange for a release not only of Purdue's claims against them, but also for a release of any claims Purdue's creditors – that is, the opioid victims – have against them.

If Purdue's plan is approved, the Sacklers – who have never filed for bankruptcy – will get the equivalent of a discharge of their liabilities related to the opioid crisis. What's more, the release of the Sacklers bind all of Purdue's creditors, regardless of their consent.

In short, the Sacklers will get the benefits of bankruptcy without having to go through the bankruptcy crucible. They



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will not have to make public disclosure of the finances under penalty of criminal law. They will not have to surrender control of their assets to an independent trustee. And they will not have to surrender all of their wealth to their creditors, other than the minimal assets exempted by the Bankruptcy Code.

To the contrary, the Sacklers will walk away from Purdue – and the misery of the opioid crisis – billionaires several times over... And, the Sacklers will likely seek to take a \$4.275 billion tax deduction for their contribution to the Purdue bankruptcy plan. In other words, the Sacklers will emerge from their Purdue bankruptcy settlement even richer than when they went into it.

Professor Levitin further posits that there are a handful of U.S. bankruptcy judges who are “eager” to attract Chapter 11 mega cases, and must compete to get them.

Lest this sound abstract, consider the relationship between bankruptcy powerhouse “BigLaw” (actual name deleted for this article) and the Delaware bankruptcy court. In the years prior to 2017, BigLaw had previously regularly filed 3-4 large cases in Delaware annually, never going more than a few months without filing a case. Delaware got over have (sic) of BigLaw filings in these years. BigLaw, however, ran into trouble in its representation of (particular Chapter 11 debtors, names deleted) in Delaware.

After these incidents, BigLaw withdrew its business from Delaware: 327 days elapsed before BigLaw’s next Delaware filing, resulting in an unprecedented gap of 616 days between BigLaw filings in Delaware. During this time, BigLaw filed 14 megacases in other venues, particularly Houston, New York, and Richmond. The message was clear – give us grief, and we’ll take our business elsewhere.

What are the other advantages of having the “right” Judge?

Evasion of the plan confirmation process

Frequently in Chapter 11 cases, in the first few days or weeks of filing, the Bankruptcy Court approves motions for post-petition financing, restructuring support agreements (RSAs), Section 363 sales of all assets free and clear of liens or assumption of “consulting agreements” for all-out liquidation sales.

Transactions that aim to end-run safeguards of the plan process are considered “sub rosa plans” which effectively determine the outcome for all creditor constituents within the first few days or weeks of the case. The early court approval evades the requirements and safeguards for the creditor constituencies imbedded in the Chapter 11 plan of reorganization process including the right to vote on a plan.

“Payday before Mayday”

Those who control companies that file Chapter 11 frequently seek extraordinary compensation as incentive to retain them. In 2005, the U.S. Congress amended the Bankruptcy Code to limit this practice, but left a loophole for payment. Professor Levitin’s written testimony on this issue:

The Bankruptcy Code . . . makes it exceedingly difficult to offer retention bonuses to “insiders,” a group that includes the debtor’s officers and directors. While the term “officer” is not defined, it undoubtedly covers all C-suite executives with “officer” in their titles.

The Code prohibits retention payments unless the court finds that (1) the insider’s services are essential to the survival of the debtor; (2) the executive has a bona fide job offer at another business at the same or greater rate of compensation; and (3) that the payment is no more than ten times the amount of the average retention bonus paid to non-

management employees in that year.

Rather than deal with KEIPs (added, key employee incentive programs), however, debtors have increasingly turned to making payments to insiders on the eve of bankruptcy. While unseemly, this practice is currently perfectly legal; the Bankruptcy Code does not apply until the debtor files for bankruptcy.

As countries around the globe seek to modify and modernize their insolvency laws, Professor Levitin’s observations and proposed amendments to Chapter 11’s Bankruptcy Code are instructive. Despite these issues, Chapter 11 has been and continues to be an excellent strategic tool and forum to restructure and preserve economic enterprises which adds untold value to the global economy.

In fact, Chapter 11 channels virtually all issues dealing with the companies’ balance sheets, capital structures, debt structures, major contracts, employment related issues, taxes and more into a uniquely efficient and singular forum. Yet, it is prudent for the U.S. Congress to consider Professor Levitin’s recommended amendments to the Bankruptcy Code. After all, since 1978 the global economy, its industries and companies and how they are capitalized and funded have become significantly more complex, diverse and, as Lehman Brothers demonstrated, more globally interwoven.

Largely in response to the Purdue Pharma case, on 23 September 2021, Senators Warren (D-MA) and Cornyn (R-Texas) introduced the bipartisan Bankruptcy Venue Reform Act of 2021, which requires big businesses and wealthy individuals to file bankruptcy in their home states or where their largest assets are located. A step in the right direction. ■



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