By Stephen Zide, David Blabey and Nathaniel Allard

Claim Treatment or New Investment?

Eighth Circuit Affirms Decision Limiting Investment Opportunity to Only Certain Class Members

Stephen Zide
Kramer Levin Naftalis & Frankel LLP; New York

David Blabey
Kramer Levin Naftalis & Frankel LLP; New York

Nathaniel Allard
Kramer Levin Naftalis & Frankel LLP; New York

Stephen Zide is a partner, David Blabey is counsel and Nathaniel Allard is an associate with Kramer Levin Naftalis & Frankel LLP in New York.

The Eighth Circuit recently became the first circuit court to weigh in on the question of whether a chapter 11 plan may offer the right to invest in a reorganized debtor to only some creditors in a class. In affirming the rulings of the bankruptcy and district courts in the bankruptcy cases of *Peabody Energy Corp.*, the Eighth Circuit joined other courts in holding that a chapter 11 plan may treat one set of creditors in the same class more favorably so long as the more favorable treatment is on account of distinct, legitimate rights or contributions. As this ruling is the first at the circuit court level with respect to such an investment opportunity, it is worthy of close review.[1]

Background

Peabody, a U.S. coal company, filed for chapter 11 in April 2016 after its business was negatively impacted by decreased demand and prices for coal. During (and prior to) bankruptcy, disputes arose between Peabody's secured and unsecured creditors with respect to the extent of the secured creditors' liens on the debtors' assets. Once in bankruptcy, Peabody filed an adversary proceeding seeking declaratory judgment on the matter.

Following months of litigation, the parties entered mediation, which eventually expanded beyond the collateral dispute to include negotiations over the terms of a reorganization plan. The parties to the mediation included the debtors and a group of holders of the debtors' second-lien and unsecured notes that eventually joined the debtors as co-proponents of the plan (the "noteholder co-proponents"). Notably, the *ad hoc* committee of nonconsenting creditors (*i.e.*, the party that objected to the reorganization plan and appealed confirmation up to the Eighth Circuit) did not participate in the mediation.

Eventually, the mediation led to the development of a chapter 11 plan, which provided that the debtors would raise $1.5 billion in new money to fund distributions and the debtors' operations following the reorganization. The funding was to be raised pursuant to two sales of securities of the reorganized company.

First, there was a rights offering of common stock for $750 million at a discount-to-plan value of 45 percent offered to all creditors in certain classes (the "rights offering"). Second, there was a sale of $750 million in preferred stock at a discount-to-plan value of 35 percent to certain "qualifying creditors" (the "private placement") who executed agreements to (1) buy a specified amount of preferred stock, (2) "backstop" (*i.e.*, agree to purchase) any rights offering shares that were not sold, and (3) support the plan.

The amount of preferred stock available for purchase by qualifying creditors was dependent on the amount of pre-petition debt held and the point in time when the creditor became a "qualifying creditor." The first 22.5 percent of the private placement was reserved exclusively for the noteholder co-proponents. The next 5 percent of the private placement was offered to those creditors in the applicable classes that agreed to the above terms by an initial deadline. The remaining 72.5 percent was then available *pro rata* to all creditors in the applicable classes that agreed to the above terms by a final deadline. Notably, the investors that agreed to purchase the preferred stock in the first two phases were required to purchase any unsold shares of the remaining 72.5 percent of the private placement that was unsold by the final deadline.

The members of the *ad hoc* committee chose not to sign the various agreements and thus never qualified to participate in the private placement. Instead, the *ad hoc* committee submitted alternative plan proposals to the debtors. The proposals included an offer to backstop a $1.77 billion rights offering that would replace the rights offering and private placement contemplated by the plan.

After reviewing the *ad hoc* committee's proposals with their advisors and having considered them at board meetings, the debtors determined that the proposals were inferior to the debtors' plan and would add costs and delay to the reorganization process. The creditors' committee also preferred the debtors' plan over the *ad hoc* committee's proposals.

The debtors proceeded to confirmation, and by the confirmation hearing, all 20 creditor classes had voted overwhelmingly to approve the plan and approximately 95 percent of the debtors' unsecured creditors agreed to participate in the private placement. Over the *ad hoc* committee's objections, the bankruptcy court confirmed the plan on March 17, 2017.

1 The case is *Ad Hoc Committee of Non-Consenting Creditors v. Peabody Energy Corp., et al. (In re Peabody Energy Corp.)*, Case No. 18-1302, in the Eighth Circuit. Kramer Levin represented certain of the noteholder co-proponents.

The Parties' Positions and the District Court Decision

Appealing confirmation to the district court, the *ad hoc* committee argued that its members received unequal treatment for their claims, asserting that the right of qualifying creditors to participate in the private placement violated § 1123(a)(4) of the Bankruptcy Code. This section states that a plan must "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." Further, the *ad hoc* committee argued that the plan violated the good-faith requirement found in § 1129(a)(3) of the Bankruptcy Code, as it failed to maximize the value of the debtors' estate.

During the pendency of the appeal, however, the debtors began consummating the plan, and by April 4, 2017, the reorganized debtors had received the $1.5 billion pursuant to the rights offering and private placement, and had distributed millions of shares of the preferred and common stock in the newly reorganized company. The reorganized debtors also distributed more than $3.5 billion to creditors, and completed other plan-related transactions before the district court reviewed the case. Accordingly, the district court dismissed the appeal as equitably moot because the plan had been substantially consummated.

Although it found the appeal moot, the district court addressed the merits of the *ad hoc* committee's arguments and concluded that the plan complied with § 1123(a)(4) and had been proposed in good faith. The district court noted that a plan's treatment *on account of particular claims* is a different concept from the treatment that class members might separately receive on account of other rights or contributions. Thus, the consideration provided to creditors willing to provide financing commitments does not constitute treatment of the creditors' claims under § 1123(a)(4).

Further, the district court found that the bankruptcy court's finding of good faith was not erroneous, citing the "overwhelming support" for the plan by Peabody's creditors and noting that the "complexity of the issues [and] interests at stake" supported a finding that the plan was a good-faith attempt to satisfy a wide variety of stakeholders while emerging from bankruptcy with a feasible plan. The *ad hoc* committee appealed to the Eighth Circuit.

The Eighth Circuit's Decision

The Eighth Circuit, in a relatively straightforward decision, affirmed the district court on the merits.[2] Similar to the district court, the Eighth Circuit held that the ability to participate in the private placement was not "treatment for" a claim, but was consideration provided in exchange for valuable new commitments from the investors, separate and apart from their claims.

The *ad hoc* committee had sought to rely on the Supreme Court's decision in *LaSalle,*[3] a case in which the U.S. Supreme Court rejected a plan that provided the debtor's prebankruptcy equityholders with the exclusive opportunity to purchase ownership interests in the reorganized debtor. The *ad hoc* committee sought to analogize *LaSalle* to the facts of *Peabody* by arguing that just as the Supreme Court in *LaSalle* found that the opportunity provided to equityholders to purchase equity in the reorganized debtor was "on account of" its equity interests, so too in *Peabody* was the opportunity to participate in the private placement on account of the claims held by the participating creditors.

The Eighth Circuit found that *LaSalle* was distinguishable from the *Peabody* scenario in at least three ways. First, the *ad hoc* committee was not excluded from the investment opportunity in *Peabody*, as they could have participated in the private placement had they taken the necessary steps to qualify. What's more, even if they did not have the same exact ability to participate as the noteholder co-proponents, it was because they did not participate in the mediation that led to the formulation of the plan.

Second, the participating creditors in *Peabody* provided consideration in exchange for the rights they received — namely, that they agreed to support the plan, and committed to backstop the rights offering and buy the preferred stock that did not sell in the private placement, even in a volatile coal market. Third, in *Peabody* (unlike in *LaSalle*), there was no exclusive right to make proposals to the company.

Peabody considered alternative proposals (including proposals from the *ad hoc* committee) and rejected them each in turn as inferior, as they would have led to delay and increased the risk that the plan would not be confirmed.

Likewise, the Eighth Circuit found that the plan was proposed in good faith. The *ad hoc* committee had argued that there was a lack of good faith because the plan failed to maximize the value of the debtors' estate because the preferred stock was sold at a discount; the plan provided certain class members with additional benefits in exchange for settling class-wide disputes (given that the noteholder co-proponents were able to buy more preferred stock in the private placement than other members of their class who agreed to the commitments later); and the debtors employed a coercive process that induced creditors to vote to accept the plan.

The Eighth Circuit noted that a good-faith finding under § 1129(a)(3) requires a review of the "totality of the circumstances" surrounding formation of the plan. Within this framework, the court rejected each of the *ad hoc* committee's arguments. Among the factors relevant to the Eighth Circuit, the court noted that the debtors had mediated with their creditors to resolve major disputes and reached a settlement with substantial input from the negotiating parties; the plan had garnered "tremendous consensus," and members of the *ad hoc* committee could have sought to participate in the mediation that led to the plan, but chose not to do so.

The Eighth Circuit rejected the argument that the plan failed to maximize value, noting that such an argument ignores that selling the preferred stock at a discount was not done in a vacuum, but rather was one component of an interrelated settlement of a variety of issues. Forcing the debtors to sell preferred stock at full price could have jeopardized the entire settlement, and the *ad hoc* committee's arguments ignored the risks of doing so.

The Eighth Circuit then rejected the *ad hoc* committee's argument that the noteholder co-proponents received a disproportionate share of the benefits for a settlement of

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2 The Eighth Circuit did not address the equitable mootness decision of the district court.

3 *Bank of Am. Nat'l Trust & Savings Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434 (1999).

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class-wide disputes in violation of Supreme Court precedent, which, the *ad hoc* committee contended, prohibits individual members of a class from using or compromising the rights of other class members to secure benefits solely for the favored individuals.[4] The Eighth Circuit saw "no merit" in this argument because it did not take into account that the noteholder co-proponents were taking on additional obligations over other class members, such as agreeing to backstop the sale of the preferred stock.

With respect to the *ad hoc* committee's argument that the debtors employed a coercive process, the Eighth Circuit was sympathetic and found it "troubling" that creditors had to make elections before the bankruptcy court approved all of the underlying agreements and the disclosure statement. Notwithstanding that concern, the Eighth Circuit was convinced by the debtors' arguments that time was of the essence given that the volatile coal market and delay was likely to lead to significant costs to the debtors. The court also credited an argument made by the creditors' committee that without early binding commitments from the investors on the plan, the investors might have had an incentive to reject the plan if the coal market had worsened such that the investment appeared less attractive than it had at the outset.

4 *See Young v. Higbee*, 324 U.S. 204 (1945).

Key Takeaways

Peabody is an example of another appellate court adopting the straightforward rule that creditors in the same class can be treated differently, so long as that different treatment is based on distinct and legitimate rights or contributions separate from the claim.[5] In so holding, the Eighth Circuit rejected the analogy between offering creditors in a class the right to fund a plan (subject to consideration of other options) and offering an existing equityholder a truly exclusive right to invest. A key distinction from *LaSalle* is that in *Peabody*, the company evaluated and took seriously alternative proposals submitted by other parties, clearly documented the steps it took to review and analyze such proposals with its advisors and board, and persuaded the bankruptcy court that it was in the company's business judgment to approve the transactions.

Peabody also illustrates the importance of a creditor's decision to participate in mediation, suggesting that to the extent an interest-holder wants to ensure that its rights are not prejudiced as a result of a mediation process, it should seek participation as early as possible. In rejecting the appeal of the *ad hoc* committee, the court pointed to at least three occasions where the *ad hoc* committee could have — but did not — participate in the mediation that led to the plan. abi

5 *See also, e.g., Ahuja v. LightSquared Inc.*, 644 F. App'x. 24, 29 (2d Cir. 2016).

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