Clients&FriendsMemo

The Same, Only Better: Eighth Circuit Affirms Peabody Chapter 11 Plan Backstopped Rights Offering Despite Alleged Disparate Creditor Treatment Under *Peabody* Plan

September 10, 2019

On August 9, 2019, in a unanimous decision (written by a former bankruptcy judge), the Eighth Circuit Court of Appeals affirmed the confirmation of the Peabody Energy Chapter 11 plan ("**Plan**")[1] with a prominent backstopped rights offering component.[2] Rights offerings continue to proliferate in chapter 11 as a popular form of exit financing. Existing investors (creditors and equity holders) are offered the opportunity to purchase new securities in the reorganized company, usually at a healthy discount to the company's assumed value. But with substantial value at stake, backstopped rights offerings are often subject to challenge, particularly over the ability to participate, the ostensibly divergent treatment accorded similarly situated creditors, and equity holders' retention of interests in the reorganized debtor. To date, court guidance on these issues has been limited because appeals of plan confirmations often are dismissed on equitable mootness grounds. Thus, the Peabody decision provides useful guidance to both debtors and potential dissenting creditors on how a rights offering can be navigated in chapter 11.

Under the Peabody Plan, more favorable treatment was afforded to certain creditors who agreed to participate in the rights offering. Dissenting creditors argued that the plan failed to provide the "same treatment" to all claims within "a particular class," as required by section 1123(a)(4) of the Bankruptcy Code.

The Circuit Court overruled the objection and held that "a reorganization plan may treat one set of claim holders more favorably than another so long as the treatment is not for the claim but for distinct, legitimate rights or contributions from the favored group separate from the claim." In *Peabody*, the treatment of participants in the rights offering was not on account of their claims, but rather, compensated the participants for shouldering significant risks attendant to their agreement

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[1] Cadwalader represented certain creditors in the *Peabody* bankruptcy case.

[2] *Ad Hoc Committee of Non-Consenting Creditors v. Peabody Energy Corporation (In re Peabody Corp.), et al.*, Case No. 18-1302, 2019 WL 3756884 (8th Cir. Aug. 9, 2019).

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to provide backstops and other "valuable new commitments." Consequently, the Plan did not provide dissimilar treatment for the participating creditors' claims.[3]

By reaching the merits of the appeal (and not dismissing it on mootness grounds), the appellate panel provided a useful road map to navigate the plan confirmation requisites of the Bankruptcy Code and possible obstacles posed by distinguishable Supreme Court case law.

The panel also delivered a cautionary message to dissenting parties: avail yourselves of participation rights and be nimble enough to act on limited notice.

Finally, by reaching the appeal's merits and expressly declining to consider equitable mootness, the Eighth Circuit may be implicitly evidencing some skepticism about the broad application of that doctrine.

Background

The affiliated debtors (the "**Debtors**") in *Peabody* collectively constituted the world's largest private sector coal company by volume. After filing for chapter 11, the Debtors commenced an adversary proceeding to resolve a prepetition dispute between the Debtors' secured and senior-unsecured creditors over the scope of the secured creditors' liens. Mediation ensued among all parties to the adversary proceeding, including a group of seven holders of the Debtors' second-lien and senior-unsecured notes (the "**Noteholder Co-Proponents**," and collectively with the Debtors, the "**Negotiating Parties**"). By contrast, the members of an Ad Hoc Committee of Non-Consenting Creditors (the "**Ad Hoc Committee**") were not parties to the adversary proceeding, did not participate in the mediation, and did not seek to intervene.

In the mediation, the Negotiating Parties not only reached a settlement of the adversary proceeding, but also crafted the Plan and related agreements that provided a mechanism for the Debtors to raise $1.5 billion in new money.

More specifically, the Plan included two fundraising elements:

- First, the Plan required the reorganized Debtors to engage in a $750 million "Rights Offering" following reorganization. The Rights Offering allowed certain creditors to purchase common stock in the reorganized company at a 45% discount. This element was not challenged on appeal.
- Second, the Plan required the reorganized Debtors to engage in a $750 million "Private Placement" whereby qualifying creditors could purchase preferred stock in the reorganized Debtors at a 35% discount. A creditor qualified to participate in the Private Placement if it:

[3] *Id.*, at *4-5.

(1) held a second-lien note or specified unsecured claim; (2) committed to purchase a certain amount of preferred stock; (3) agreed to backstop both the Rights Offering and the Private Placement; and (4) agreed to support the Plan throughout the confirmation process by becoming a party to a plan support agreement.

The Debtors implemented a three-phase system for determining who could purchase securities in the Private Placement on a *pro rata* basis (calculated with reference to the prepetition claim amount). In phase one, the Noteholder Co-Proponents were given the exclusive right to purchase the first 22.5% of preferred stock at the discounted price. In phase two, the Noteholder Co-Proponents, plus any creditor in the relevant classes who took action to qualify within a few days of the announcement of the Private Placement (collectively, the "**Phase-Two Investors**"), received the exclusive right to purchase the next 5% of the preferred stock at the discounted price. Finally, in phase three, the Noteholder Co-Proponents and the Phase-Two Investors, plus any eligible creditor who took action to qualify after phase two but before the close of the sale, received the exclusive right to purchase the remaining 72.5% of preferred stock at the discounted price.

The three-phase system (together with certain allocation adjustment provisions) awarded the Noteholder Co-Proponents, who held approximately one-third of the claims in the relevant classes, over two-thirds of the preferred stock offered in the Private Placement. Without the Rights Offering and Private Placement, projected recoveries were 52.4% on second-lien note claims and 22.1% on unsecured notes.

Approximately 95% of unsecured creditors agreed to participate in the Private Placement and to make the necessary "backstop" commitments, and every class of creditors voted "overwhelmingly" in favor of the Plan. However, the Ad Hoc Committee chose not to participate in the Private Placement and, instead, made alternative restructuring proposals that were rejected by the Debtors and the Unsecured Creditors Committee. The Bankruptcy Court confirmed the Plan and approved the Private Placement agreement over the Ad Hoc Committee's objection.

The Ad Hoc Committee appealed the confirmation order to the District Court, arguing that the Private Placement agreement: (1) violated the "same treatment" requirement prescribed in Bankruptcy Code section 1123(a)(4) because participation in the Private Placement was not offered on equal terms to all creditors of a particular class; and/or (2) violated the "good faith" requirement of Bankruptcy Code section 1129(a)(3) because it failed to maximize the value of the Debtors' estate.[4]

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[4] *See Ad Hoc Committee of Non-Consenting Creditors v. Peabody Energy Corporation, et al. (In re Peabody Corp.)*, 582 B.R. 771, 779 (E.D. Mo. 2017).

A stay pending appeal was denied and a number of transactions under the Plan were completed, including: (1) the Private Placement and Rights Offering; (2) exit financing; (3) satisfaction (in full) of the Debtors' first-lien obligations and (in part) of the Debtors' second-lien obligations; (4) issuance and distribution of approximately 30 million shares of new preferred stock and approximately 72 million shares of new common stock; (5) assumption or rejection of thousands of contracts and leases; and (6) cancellation of the Debtors' old debt and equity securities.

Ultimately, the District Court found the appeal to be equitably moot because: (1) the Plan had been substantially consummated; (2) no stay was in place pending appeal; (3) reversal of the Plan would require "unraveling complex transactions undertaken after the Plan was consummated"; and (4) public policy dictated finality and reliability in bankruptcy judgments.[5] In the alternative, the District Court affirmed the Bankruptcy Court on the merits, specifically finding that the equal treatment requirement of 1123(a)(4) and the "good faith" requirement of 1129(a)(3) had been satisfied.[6] The Ad Hoc Committee appealed to the Eighth Circuit.

Eighth Circuit Decision

The Eighth Circuit affirmed the District Court's ruling on the merits with respect to both the equal treatment and the good faith issues. It declined to address the equitable mootness issue.

Equal Treatment (Bankruptcy Code Section 1123(a)(4))

Section 1123(a)(4) of the Bankruptcy Code 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."[7] The Ad Hoc Committee argued that the right of the Noteholder Co-Proponents and other qualifying creditors to participate in the Private Placement constituted unequal treatment for their claims.

In response, the Eighth Circuit held that a plan may treat one set of claim holders more favorably than another so long as the treatment is not on account of the claim itself, but in exchange for distinct, legitimate rights or contributions provided by the favored group. The Eighth Circuit found that the opportunity to participate in the Private Placement was not "treatment for" the participating creditors' claims. Rather, it was consideration for valuable new commitments made by the

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[5] *See Peabody*, 582 B.R. at 779-81. The doctrine of equitable mootness allows a court to dismiss bankruptcy appeals when the court has jurisdiction to grant relief, but implementation of such relief would be inequitable. *See In re Philadelphia Newspapers, LLC*, 690 F.3d 161, 168 (3d Cir. 2012). In that regard, equitable mootness is "a prudential doctrine that protects the need for finality in bankruptcy proceedings and allows third parties to rely on that finality" by "prevent[ing] a court from unscrambling complex bankruptcy reorganizations when the appealing party should have acted before the plan became extremely difficult to retract." *See In re Ornet Corp.*, 355 B.R. 37, 40-41 (S.D. Ohio 2006).

[6] *See Peabody*, 582 B.R. at 781-84.

[7] 11 U.S.C. § 1123(a)(4) (emphasis added).

participating creditors, who had promised to support the Plan, buy preferred stock, and backstop the Rights Offering and the Private Placement.

The Eighth Circuit found unpersuasive the Ad Hoc Committee's arguments based on the Supreme Court's *North LaSalle* decision.[8] In *North LaSalle*, the Supreme Court rejected a plan because it violated the absolute priority rule by giving a debtor's pre-bankruptcy equity holders the exclusive opportunity to receive ownership interests in the reorganized debtor if the equity holders would invest new money. The Supreme Court specifically found troubling the fact that the equity holders had paid nothing for the valuable exclusive opportunity and that the debtor had not considered any alternative ways of raising capital.[9]

The Eighth Circuit distinguished *North LaSalle* from *Peabody* in three ways:

- First, the Ad Hoc Committee was, in the Eighth Circuit's view, not excluded from any opportunity. Although the Ad Hoc Committee was technically excluded from participating in the very first phase of the Private Placement, the Court suggested in a footnote that the Ad Hoc Committee could have secured the right to participate in this first phase by moving to intervene in the mediation in which the Private Placement was negotiated.[10]
- Second, creditors who participated in the Private Placement gave something of value in exchange for their right to participate: they promised to support the Plan, buy preferred stock, and backstop the Rights Offering and Private Placement.
- Third, the *Peabody* Debtors and the Official Creditors Committee considered several alternative ways to raise capital, including proposals submitted by the Ad Hoc Committee.

Good Faith (Bankruptcy Code Section 1129(a)(3)):

A bankruptcy court "shall confirm a plan only if . . . [t]he plan has been proposed in good faith."[11] The Ad Hoc Committee argued a lack of good faith for three reasons: (1) "the Plan failed to maximize the value of the Debtors' estate" because the preferred stock was not sold for its full value; (2) "the Plan gave certain class members additional benefits in exchange for settling class-wide disputes" by permitting the Noteholder Co-Proponents to buy more preferred stock in the Private Placement than other members of their class; and (3) "the Plan Proponents employed a coercive process that induced holders to vote to accept the Plan," given that creditors who wished

8 *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999).

9 426 U.S. at 456.

10 *Peabody,* 2019 WL 3756884, at *5 n.3.

11 11 U.S.C. § 1129(a)(3).

to participate in the Private Placement (and receive the related economic benefits) had to sign a plan support agreement and give up their right to object to the Plan.

The Eighth Circuit held that the Bankruptcy Court did not err in finding that the Debtors proposed the Plan in good faith. The record showed that: the Debtors mediated with their creditors to resolve a major dispute; the Ad Hoc Committee could have intervened in that mediation if it had chosen to do so; the Plan garnered tremendous consensus; and the Debtors considered alternative plans, including those offered by the Ad Hoc Committee.

The Eighth Circuit acknowledged that "the Debtors might have made more money selling the preferred stock at full price," but noted that the Debtors might not have convinced the parties to the lien dispute to settle or commit to the other agreements if the Debtors had not offered them preferred stock at a discount.[12] Further, while the Eighth Circuit conceded that the Noteholder Co-Proponents obtained a disproportionate opportunity to participate in the Private Placement, it viewed this disparity as justified given that the Noteholder Co-Proponents took on more obligations than other members of their class.

Finally, although the Eighth Circuit was "somewhat sympathetic" to the argument that "the Debtors coercively solicited votes in favor of the plan" and also found "troubling" the constraints in creditor participation,[13] the Court was convinced by the Debtors' argument that these aspects of the plan process were necessary because time was of the essence given the volatile nature of the coal market.

Dissenting Creditors Be Warned

In *Peabody*, the Eighth Circuit: (1) provided a veritable blueprint of some methods a debtor can use to channel extra value to favored creditors in exchange for plan support while still remaining in technical compliance with the Bankruptcy Code; and (2) joined several other circuits that have held that section 1123(a)(4)'s equal treatment requirement applies only to the treatment that a class member receives "for" its claim and not to treatment a class member receives "in exchange for" other contributions.[14]

Peabody and similar decisions therefore suggest that debtors have considerable latitude to provide special treatment to particular creditor groups in exchange for support, so long as this unequal

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[12] *Peabody,* 2019 WL 3756884, at *6.

[13] *Id.*, at *7.

[14] *See Ahuja v. LightSquared Inc.*, 644 F. App'x 24, 29 (2d Cir. 2016); *Mabey v. Sw. Elec. Power Co. (In re Cajun Elec. Power Coop., Inc.)*, 150 F.3d 503, 518-19 (5th Cir. 1998); *Acequia, Inc. v. Clinton (In re Acequia, Inc.)*, 787 F.2d 1352, 1358 & n.4 (9th Cir. 1986).

treatment plausibly can be characterized as being in exchange for some form of "new value" contribution.

Dissenting creditors are cautioned: statutory confirmation requirements may not be readily employed to derail rights offerings, and they should be prepared to participate on limited notice.

Finally, the Eighth Circuit's decision not to address "equitable mootness" could suggest that the Court was at least somewhat skeptical of that doctrine, which recently has come under increased scrutiny in other circuits as well.[15]

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[15] *See One2One Communs., LLC v. Quad/Graphics, Inc.*, 805 F.3d 428, 438 (3d Cir. 2015) (Krause, J. concurring) (criticizing equitable mootness on statutory, constitutional and prudential grounds); *see also In re City of Detroit*, 838 F.3d 792, 812 (6th Cir. 2016) (Moore, J., dissenting) (arguing that "it is high time for us to review the [equitable mootness] doctrine's basis").