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Bankruptcy Cases To Watch In 2018

By **Alex Wolf**

Law360, New York (January 1, 2018, 3:04 PM EST) -- As a new year in the world of financial restructuring unfolds, bankruptcy attorneys should not just be keeping tabs on the huge companies and entire U.S. territory that have recently fallen on hard times, but they should also be tracking the cases that have raised new questions about bankruptcy procedures and the ability of creditors to recover.

With cases that challenge the jurisdictional authority of bankruptcy courts, the extent to which safe harbor rules protect prepetition transfers from clawback, the federal government's efforts to restructure the commonwealth of Puerto Rico, and the durability of the retail industry, 2018 should be an exciting year for restructuring practices across the country.

Here are some of the matters that bankruptcy attorneys should be closely monitoring.

Merit Management Group LP v. FTI Consulting Inc.

What could be more buzzworthy than a bankruptcy case in front of the U.S. Supreme Court that has the potential to disrupt billions of dollars in other cases?

Taken up by the justices last year, Merit Management Group v. FTI Consulting concerns the scope of the Bankruptcy Code's "safe harbor" provision exempting certain securities transactions from clawbacks.

The case involves a dispute over whether the Seventh Circuit was correct **in its 2016 decision**, in which it found that a safe harbor provision forcing trustees to honor transfers to securities and financial institutions doesn't protect transfers that only move through those institutions.

The decision created a circuit split over how Section 546(e) of the code should be interpreted, particularly over whether it protects transfers in which the institution is just a conduit.

That section states that a trustee may not avoid or claw back transfers "by or to (or for the benefit of)" financial institutions and various other types of entities — a provision that Congress enacted to protect the integrity of capital markets.

The ruling is expected by some to have ripple effects that could affect market participants, especially those that have performed leveraged buyouts.

In July, former shareholders of Lyondell Chemical Co. and Tribune Co. facing 10-figure clawback suits **warned that allowing** the Seventh Circuit decision to stand could inject uncertainty into transactions and drastically disrupt the marketplace. Both Tribune and Lyondell were publicly traded until 2007, when they were taken private in massive leveraged buyouts.

"Based on this decision, you could have a $20 billion swing in distributions in two major bankruptcy cases," said Robert Gayda of Seward & Kissel LLP. "You would think that leverage in any future bankruptcy cases that arise out of LBO transactions could also be affected."

Practitioners are eagerly waiting to find out whether the high court sides with the Seventh Circuit's interpretation of the rule or if it accepts the broader view of safe harbor espoused by the Second,

Third, Sixth, Eighth and Tenth circuits. A decision is expected in the coming months now that oral arguments **are in the books**.

"It's going to be an interesting decision," Richards Kibbe & Orbe LLP attorney Gregory Plotko said. "I think Merit Management is going to be the top bankruptcy case decided in 2018."

Toys R Us Inc.

Before the book can be written about how the retail industry was affected by the rise in online shopping and how large merchants either survived through restructuring or had their tombstones added to the retail graveyard, the outcome of Toys R Us' Chapter 11 bankruptcy must be observed.

The iconic children's toy chain and owner of Babies R Us filed for **Chapter 11 protection** in September with a whopping $5 billion in funded debt, stemming in large part from money its owners borrowed in 2005 to fund a $6.6 billion leveraged buyout of the company and take it private.

The company, set to scale down its physical footprint from 1,600 Toys R Us and Babies R Us locations, secured a $3.1 billion debtor-in-possession loan and **bet big on sales** during the 2017 holiday shopping season. Now it remains to be seen if Toys R Us can successfully reorganize and strike a balance that allows it to turn a profit from online and in-store sales.

"The thing that makes Toys R Us so interesting is that they're actually trying to reorganize, and that doesn't happen very often with retail these days," said Ted Gavin of corporate restructuring firm Gavin Solmonese LLC. "You don't see reorganizations. You see quick sales."

While the case carries significance in the world of restructuring professionals, the outcome could have huge implications for retail employees and consumers at large, according to Hugh Ray, McKool Smith PC's bankruptcy practice leader, as it could be a bellwether for the future of big-box stores.

"It will be watched by the guy in charge of layaway at the Kmart and the economists as well," he said.

Westinghouse Electric Co.

Nuclear contracting giant Westinghouse **landed in bankruptcy** in early 2017 after parent Toshiba Corp. reported that the unit would have to book a $6.1 billion write-down for cost overruns at its two nuclear reactor construction sites in the United States.

While in bankruptcy, the company has rid itself of its obligations to finish the U.S.-based nuclear reactor projects thanks to multibillion-dollar severance payments from Toshiba, and it is currently looking to execute a sale of the business to maximize creditor recoveries and emerge from Chapter 11.

Although the debtors have stated that they are in talks with qualified suitors and are poised to finalize a transaction in the first quarter of 2018, the case could be prolonged by President Donald Trump and other U.S. officials who have the ability to prohibit any merger, acquisition or takeover that "could result in foreign control of any person engaged in interstate commerce in the United States."

In a June letter to the bankruptcy judge presiding over the Westinghouse case, the **U.S. attorney's office warned** that a review by the Committee on Foreign Investment in the United States "could affect the transactions' timing, terms, and ability to be completed."

At a time when nations with nuclear capabilities have been jockeying for greater influence in the global community and the threat of nuclear disaster has been amplified by the exchange of caustic language between leaders of the U.S. and North Korea, the sale of nuclear technology is one that will be closely monitored by those at the top, according to Anthony Sabino, a St. John's University School of Law professor.

"This is a crucial case to be watched," he said. "This is not just a bankruptcy case. You're dealing with atomic power. You're dealing with nuclear energy. This is a case that's being decided in a heightened

geopolitical climate."

According to Sabino, the Westinghouse case is going to be driven not so much by the dollars involved but by nonbankruptcy issues of energy policy, national security and foreign relations.

Takata Corp.

The Japanese manufacturer was pushed into bankruptcy following the onset of multidistrict litigation and massive global recalls over its widely used vehicle air bag inflators, which allegedly have a tendency to explode.

The company is now hoping to **pull off a restructuring** that culminates in a $1.6 billion bankruptcy sale to competitor Key Safety Systems Inc., with proceeds going toward the $825 million still owed from Takata's $1 billion criminal plea deal with the U.S. Department of Justice in 2016.

Takata's automaker customers consist of major industry players like Toyota Motor Corp., Ford Motor Co. and Honda Motor Co. Ltd., which are providing the debtor with an unusual form of post-petition financing by forgoing payment rights to free up an estimated $300 million in liquidity to keep the company afloat.

In a ruling shortly after Takata entered Chapter 11, the judge in the bankruptcy case granted the manufacturer the customary litigation stay relief, delaying hundreds of lawsuits and government enforcement actions to allow the company to focus on restructuring. The judge also extended the stay to the automakers that sold vehicles with defective Takata products in them.

Therein lies the rub. If the nondebtor companies inextricably tied up in Takata's product liability claims can enjoy the same temporary relief as the parts maker, can they also find a way to permanently win a release?

"I see the case as really one of: 'Who is entitled to obtain releases under a Chapter 11 plan from the bankruptcy court?'" said Jeanne P. Darcey, a partner with Sullivan & Worcester LLP's bankruptcy and restructuring group. "Is there jurisdiction for the bankruptcy court to grant a release in favor of a nondebtor third-party?"

Millennium Lab Holdings II LLC

The extent of constitutional authority held by U.S. bankruptcy judges is under a microscope in the Chapter 11 case of lab testing company Millennium Lab Holdings II LLC. In October, the Delaware bankruptcy judge presiding over the case ruled that she **had constitutional authority** to grant liability releases in a plan confirmation order without creditor consent in favor of nondebtor parties for claims that stem from outside of the bankruptcy case.

The uncommon form of liability release was granted over the objection of a group of creditors led by Voya Investment Management, which, under the approved plan, is prevented from bringing racketeering claims against the debtor's departing owners.

The ruling, issued after a district court remanded the matter back to the bankruptcy court in July for clarification on the constitutional authority issue, could go a long way toward clarifying confusion created in 2011 when the U.S. Supreme Court limited the power of bankruptcy judges to resolve certain claims in bankruptcy proceedings with its decision in Stern v. Marshall, according to attorney Benjamin D. Feder of Kelley Drye & Warren LLP.

The Stern decision, which dealt with a dispute between Anna Nicole Smith and the estate of her late husband J. Howard Marshall II, held it to be unconstitutional for a bankruptcy court, created pursuant to Congress' bankruptcy power under Article I of the Constitution rather than under Article III, to issue a final order on certain counterclaims based on state law that would not be resolved through the proof of claim process.

Voya argued that granting the releases in Millennium's reorganization plan was tantamount to a resolution of the racketeering claims in contravention of Stern. U.S. Bankruptcy Judge Laurie Selber Silverstein disagreed, finding that the releases were ancillary to her unquestionable constitutional

authority to confirm the plan.

Feder contends that the high court's ruling has created uncertainty over the extent to which the power of bankruptcy courts to issue final orders is limited by their status as Article I courts. By finding that Stern does not block her from approving the nonconsensual releases sought by Millennium Lab Holdings, Judge Silverstein has created a vehicle to clarify the constitutional authority of bankruptcy courts, he said.

"The importance of Millennium Lab Holdings and why people will be watching it carefully will be to see whether the Third Circuit Court of Appeals eventually will adopt the straightforward and pragmatic approach articulated by Judge Silverstein," Feder said.

Should Judge Silverstein's view carry the day, it's possible that a lane will open up in other cases, like Takata, for third parties to gain a permanent release from litigation.

Puerto Rico

In what amounts to the nation's largest municipal bankruptcy, the commonwealth of Puerto Rico and its public companies have been attempting to restructure a crippling $74 billion public debt load and an additional $50 billion in pension liabilities.

The bankruptcy-like cases initiated in May under the Puerto Rico Oversight, Management and Economic Stability Act, commonly known as PROMESA, are being used to address a flurry of competing claims for payment while attempting to keep the struggling territory afloat.

The restructuring process, which is being overseen by a federally appointed board of financial professionals, has been complicated by a growing list of disputes, including those over liens on public revenues, over investigations into what caused the debt crisis, and most recently over the devastation caused by Hurricane Maria, which has forced officials to revise fiscal recovery plans altogether.

While Puerto Rico is facing myriad legal disputes, it also lacks a comprehensive plan to revitalize the island and restore investment opportunities, and it's wrapped in uncertainty over the extent to which the federal government will provide financial assistance.

"What will happen going forward is very much in the air," said Stephen Pezanosky, a Haynes and Boone LLP attorney.

In spite of the fact that a tangled web of creditor disputes and constitutional challenges had to be resolved before the restructuring cases could be settled, long-term budgetary blueprints were previously in place, and "there at least was a path that folks thought might lead to some kind of a conclusion," Pezanosky said.

"All of that got completely derailed, in our view, when the two hurricanes hit Puerto Rico, particularly Maria," he added. "It just decimated the island."

Puerto Rico had already been buckling under a mountain of municipal debt obligations, double-digit unemployment figures and continual out-migration of residents to the continental U.S. Then, in September, the island was ravaged by the strongest hurricane to hit it since 1932, just two weeks after taking a partial beating from Hurricane Irma. Damage from the recent storms could total as much as $95 billion, according to some reports.

The restructuring proceedings have resumed since the storms hit, but the recovery schemes have been flipped on their head after the board declared that fiscal plan revisions were needed and the governor asked the federal government for $95 billion in aid amid heightened scrutiny over the local government's transparency and credibility.

Right now the big question is: "How do you put forward a restructuring plan when the opportunities for recovery and new investment still are so uncertain?" said Melissa Jacoby, a University of North Carolina School of Law professor. "It's such a hard problem to solve."

--Additional reporting by Matt Chiappardi. Editing by Jeremy Barker and Catherine Sum.