Simpson Thacher

Memorandum

Bankruptcy Court Applies Favorable Standard in Considering Sponsor Releases Under Plan

October 24, 2017

On September 8, 2017, Judge Gregory Taddonio, of the United States Bankruptcy Court for the Western District of Pennsylvania, confirmed the rue21, inc. debtors' Chapter 11 plan of reorganization, which included a full release of Apax Partners, rue21's equity sponsor. The Court's decision overruled objections by the unsecured creditors committee (the "UCC") to the release of the company's claims against Apax Partners related to their role as equity sponsor in the company's 2013 take-private transaction. The UCC claimed that as part of the transaction, Apax and certain affiliates may have received constructive fraudulent transfers, as one Apax affiliate, SKM, received a reported $300 million as the largest existing shareholder, and that Apax had not contributed sufficient value to the restructuring to justify the release under the *Master Mortgage* factors described below. rue21 and Apax contended that the potential claims against Apax were meritless – rue21's independent directors had commissioned an independent investigation led by independent counsel which supported this conclusion – and that the release of Apax was justified and in the best interest of the estates. The conclusion that the potential fraudulent transfer claims were meritless was based first and foremost on binding Third Circuit Court of Appeals precedent that distributions received by SKM in a take-private transaction constituted settlement payments by a financial institution under the section 546(e) safe harbor provision and are thus protected from a constructive fraud claim. Nevertheless, the UCC claimed that because a case before the United States Supreme Court this term, an appeal of *Merit Management*, could potentially reverse this binding precedent protecting Apax from the claim, the Court should devise a 'creative solution' to preserve these potential claims for the benefit of the estate.

Judge Taddonio heard arguments at the August 23 Confirmation Hearing regarding these potential claims and the 2013 take-private transaction by Apax and issued an opinion confirming the Chapter 11 plan as submitted, including the Apax release. The Court held that the analysis to approve the release must go beyond a simple business judgment rule standard for the debtors. The decision instead was an augmented application of *Master Mortgage* factors tailored to the facts of the case including, critically, an analysis of the colorability of the potential claims.

The Business Judgment Rule Found Not to Apply

The debtors argued that the release of Apax represented a settlement of claims, and therefore a reasonable application of their business judgment to settle and release the Apax claims was sufficient. The debtors had appointed a committee of independent directors to investigate any potential claims against Apax that may arise from the 2013 transaction. The independent directors retained Reed Smith LLP which issued a 79-page investigative report determining there were no colorable claims against Apax. The debtors contended that their decision to release Apax in consideration of these findings constituted a settlement of claims, for which the business judgment standard applies.

The UCC, on the other hand, argued that the *Master Mortgage* factors should be applied in determining the propriety of the release, including:

1. whether there was an identity of interest between the debtor and released party such that a suit against the released party will deplete the estate's resources;
2. whether there was a substantial contribution to the plan by the released party;
3. the necessity of the release to the reorganization, to the extent that, without the release, there is little likelihood of success;
4. the overwhelming acceptance of the plan and release by the creditors and interest holders; and
5. the payment of all or substantially all of the claims of the creditors and interest holders under the plan.

Judge Taddonio held that because the record lacked sufficient evidence to demonstrate the release was intended to be a 'settlement of a claim' rather than an integrated component of the plan, that the *Master Mortgage* factors should instead serve as a guideline.

Release Found to be Justified Under any Applicable Standard

Addressing the *Master Mortgage* factors one by one, the Court found that the Apax release indeed satisfied the *Master Mortgage* standard. While no identity of interest between the debtor and Apax was found, the Court moved to the second point, determining whether a 'substantial contribution' was made by Apax in exchange for the release.

'Soft Contributions' Found to Satisfy the *Master Mortgage* Substantial Contribution Requirement

The Court's decision, departing from Delaware precedent in a manner favorable to equity sponsors, found that although Apax provided no monetary contribution or tangible assets to the plan, substantial value was nonetheless provided. The Court instead gave weight to non-monetary contributions provided by Apax when signing the RSA and facilitating the restructuring process. The decision reasoned that Apax's agreement in the RSA to forego declaring a worthless stock deduction constituted substantial value, as it resulted in potential savings for the reorganized debtors through preservation of tax attributes, potentially offsetting millions of dollars in taxable income. Additionally, Apax bore significant opportunity costs by forfeiting these deductions to reduce its own tax liabilities.

Judge Taddonio went on to hold that the remaining *Master Mortgage* factors were satisfied, finding the releases were a necessary component of the "multi-party agreement by which Debtors were able to achieve consensus to support a plan of reorganization on an expedited track." The decision emphasized that the plan received overwhelming support from all of the debtors' stakeholders, with 100% support among prepetition secured term loan lenders and 93% support of general unsecured creditors even though any value to unsecured creditors is dependent on future performance and will be nowhere near full payment.

Claim Colorability Added to the *Master Mortgage* Analysis

Although the standard five *Master Mortgage* factors were addressed, the judge found that the case at hand called for an augmentation of this framework. The factors, the decision points out, are not binding and are to serve as a mere guideline to frame the Court's fact-specific inquiry into each case. Because the debtors in this case indicated that they would not pursue claims against Apax even if the claims were not released, any party wishing to commence claims would have to obtain derivative standing, which requires that the existence of a colorable claim must be established. Therefore, the Court reasoned, colorability of the potential claim in this case is "one of the most prominent considerations because, if the released claims have no value, the other factors are largely irrelevant." In other words, a party should not have to make a substantial contribution in order to receive a release of claims that are baseless and have no value.

Potential Claims Against Apax Found to be Legally Barred and Thus Not Colorable

The Court concluded that the claims against Apax have no merit and are barred as a matter of law. The UCC conceded that, under existing Third Circuit precedent, the claims are barred by the 546(e) safe harbor but suggested the Court not follow this precedent and instead preserve the Apax claims pending a possible reversal of that precedent by the Supreme Court. The Court rejects this on *stare decisis* grounds, noting that the Court "'takes its marching orders' from the Third Circuit… Simply stated, this Court has no authority to ignore binding precedent from its Court of Appeals."

In concluding the decision, the Judge Taddonio held that "[a]fter considering the evidence presented at the confirmation hearing, the Court finds no basis to delay confirmation pending a ruling that may never come. It also finds no basis to materially rewrite a plan that the creditor body overwhelmingly accepted." The Court approved the plan, dismissing the UCC bid to carve out the releases, seeing "no compelling reason to exclude Apax from the release provisions of Article VIII.C of the plan."

While clearly a positive outcome for Apax, looking ahead, the holding in this case is favorable for equity sponsors generally. The Court's willingness to scrutinize the colorability of claims in addition to the traditional *Master Mortgage* factors is advantageous in preventing sponsors from being "held up" and forced to contribute to the settlement of meritless claims. Further, the decision suggests that sponsors are not strictly bound to provide tangible or financial support in order to lend value to a restructuring within the *Master Mortgage* framework and that Courts may be willing to recognize a sponsor's non-monetary contributions in facilitation of restructuring processes.

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