BANKRUPTCY COURT PAVES THE WAY FOR EXCLUDED BONDHOLDERS TO SEEK RECOVERIES FROM PRE-PETITION LIABILITY MANAGEMENT TRANSACTION

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Introduction

In a recent decision in the Chapter 11 proceedings of Wesco Aircraft Holdings, Inc., operating as "Incora" ("Incora" or the "Debtors"),[1] Judge Isgur tackled the limits of a pre-petition liability management transaction that, among other things (i) favored a certain group of bondholders (the "Participating Holders") while excluding other holders[2] (the "Excluded Holders"), (ii) subordinated the Excluded Holders' claims, and (iii) released the Excluded Holders' liens that secured such claims (the "Transaction"). By denying summary judgment on a majority of these claims, Judge Isgur paved the way for the Excluded Holders to proceed to trial against the Debtors, the Participating Holders, the Debtors' private equity sponsor and the indenture trustee (the "Trustee") that was party to the Transaction.

Background

Incora was the product of a nearly $2 billion 2019 leveraged buyout by its equity sponsor. In 2022, to address liquidity issues, the Debtors and the Participating Holders entered into the Transaction pursuant to which the Participating Holders provided the Debtors with new financing that involved, among other things (i) amending the applicable indentures by majority vote to permit the issuance of additional notes to the Participating Holders, (ii) offering such additional notes on a non pro rata basis only to the Participating Holders, (iii) exchanging the Participating Holders' notes for such additional notes that were secured and had a higher priority liens, and (iv) releasing the liens securing the notes of the Excluded Holders. Thereafter the Excluded Holders challenged the Transaction in New York state court, asserting claims against Incora, the Participating Holders, the Trustee and Incora's equity sponsor, for among other things, (i) breach of the indenture agreements, (ii) breach of the implied covenant of good faith and fair dealing, and (iii) tortious interference.

On June 1, 2023, Incora filed for bankruptcy in the Bankruptcy Court for the Southern District of Texas and simultaneously commenced an adversary proceeding against the Excluded Holders seeking to ratify the Transaction. The Excluded Holders filed a counter-complaint. On January 14, 2024, and January 23, 2024, Judge Isgur issued opinions on the parties' motions for summary judgment.

The Opinion

A. Threshold Rulings

Addressing the issue of whether the court had subject matter jurisdiction over certain claims against non-debtors, Judge Isgur concluded the contractual indemnification obligations under the governing indentures implicating Incora were sufficient to give rise to "related to" jurisdiction with respect to the claims asserted against the Trustee and the Participating Holders. With respect to jurisdiction over the standing claims of the Excluded Holders, the court concluded (i) the standing claims were core and (ii) the contract and tort claims were non-core as they were state law-based, suggesting that other "excluded" investors could litigate similar liability management claims outside of a bankruptcy court.

Turning to whether certain claims asserted by the Excluded Holders against non-debtor parties were property of the bankruptcy estate, the court ruled that they were not, which claims included declaratory relief of liability regarding standing, breach of contract, breach of the implied covenant of good faith and fair dealing, tortious interference with contract, and conversion. The breach of contract claims included breaches of indenture provisions, including provisions governing redemption, non-impairment, and direction, each discussed below.[3]

B. Breach of Contract Claims

Judge Isgur denied summary judgment for most of the breach of contract claims asserted by the Excluded Holders against the Debtors and the Participating Holders, finding there existed genuine issues of disputed facts regarding (i) whether all the agreements involved in the Transaction were interrelated such that it would be deemed an integrated transaction (as opposed to each agreement being viewed as independent, resulting in independent multiple transactions) and (ii) the indenture provisions themselves, which the court found to be ambiguous, including those on redemption, non-impairment and directions.[4]

[1] *See* In re Wesco Aircraft Holdings, Inc., et al. v. SSD Investments Ltd., No. 23-90611, 2024 WL 156211 (Bankr. S.D. Tex. Jan. 14, 2024); and In re Wesco Aircraft Holdings, Inc., et al. v. SSD Investments Ltd., No. 23-90611, 2024 WL 255855 (Bankr. S.D. Tex. Jan. 23, 2024).

[2] The Excluded Holders included Langur Maize, a party to this litigation.

[3] The court concluded the claims for equitable lien and equitable subordination were disguised fraudulent conveyance claims that were property of the Incora estate and were thus dismissed.

[4] Judge Isgur granted summary judgment and dismissed the Excluded Holders' claims for (i) breach of the implied covenant of good faith and fair dealing as being duplicative of the breach of contract claims, (ii) conversion, (iii) breach of contract against the Trustee due to the indentures' indemnification provisions and (iv) unjust enrichment claims as the court viewed the indentures are valid contracts.

Notably, Judge Isgur's opinion is a departure from a decision by Judge Jones, also of the Bankruptcy Court of the Southern District of Texas, in the Chapter 11 case of *Serta Simmons Bedding, LLC* ("*Serta*"),[5] who ruled that a pre-petition "uptier" exchange transaction, comprised of the issuance of priming super priority debt through amendments in exchange for existing first and second lien debt to a group of majority lenders at a discounted value, did not violate the existing credit agreement. The *Serta* transaction had the result of subordinating and devaluing the existing debt of non-participating lenders, who later argued (unsuccessfully) that (i) this priming transaction violated the applicable *pro rata* sharing provision under the credit agreement and (ii) the debtor and the participating lenders violated the implied covenant of good faith and fair dealing. In ratifying the transaction, Judge Jones also noted that the participating lenders did not breach the implied covenant of good faith and fair dealing by their participation and extolled the inherent fairness of an "open market" process of soliciting interest from existing lenders.

With respect to the indentures' redemption provisions, the Excluded Holders argued (i) such provisions required a *pro rata* redemption or purchase of the notes if less than all the notes were to be redeemed and (ii) by selecting the Participating Holders' notes for exchange, instead of a *pro rata* apportionment amongst all the noteholders, the Participating Holders were placed in a better position upon a default. Judge Isgur concluded there was a genuine dispute as to whether the Transaction was a redemption (requiring the Trustee to select notes for redemption or purchase on a *pro rata* basis) or an exchange pursuant to an open market or privately negotiated transaction, as argued by the Debtors and the Participating Holders.

The Excluded Holders also argued the indentures' non-impairment provisions (also known as "sacred rights"), which required the consent of each affected holder if any supplement or waiver adversely affected such holder, were violated when the priority of payment provisions were changed without their consent. Judge Isgur concluded "the right of payment" was ambiguous, questioning whether such right applied to changes in rankings or of lien stripping. Finally, the Excluded Holders also argued the Participating Holders' direction to the Trustee to retire only their notes for purchase in the exchange was an improper direction. Citing disputed facts as to the Trustee's action in retiring the notes (or not refusing to retire the notes), which turns on whether the Participating Holders' actions were allowed under the indentures, Judge Isgur denied summary judgment. Judge Isgur's preliminary analysis on such point turned on the word "may" as to whether the Trustee was obligated to use its reasonable discretion to refuse to retire the notes as unlawful and in violation of the indentures.

C. Langur Maize's Standing

The Debtors and others alleged, among other things, that Langur Maize did not have proper standing to sue non-debtor entities under Article III of the Constitution, which requires a showing that Langur Maize suffered an injury-in-fact. Pursuant to N.Y. G.O.L. § 13-107, a transferor's bond-related claims against an obligor,

indenture trustee, depositary or guarantor is automatically assigned without the need for a formal assignment of claims.[6] The court found that while Section 13-107 applied to Langur Maize's claims against the Debtors, the Trustee and all applicable guarantors, thereby providing for appropriate Article III standing, Section 13-107 did not apply to parties not expressly mentioned in the statute (which included the Participating Holders) and as such, Langer Maize was required to establish that it (i) had been assigned its claims by an entity with standing or (ii) personally suffered an injury-in-fact.

With respect to standing through assignment, Langur Maize argued it had the requisite standing as The Depository Trust Company ("DTC"), as record holder of the applicable notes, provided Langur Maize authorization to bring its claims in New York state court and the bankruptcy court. The court concluded DTC, as the record holder, did not have a claim assignable for standing purposes because as the record holder, DTC had no actual interest in the underlying notes beyond just holding them in the form of a global security; rather, the beneficial owners of the applicable notes were the holders and thus the real parties in interest.[7]

Thus, for Langur Maize to have standing, it was required to show it suffered an injury-in-fact.[8] The court concluded there existed a genuine issue of material fact as to whether Langur Maize suffered an injury-in-fact for claims not assigned other than by operation of Section 13-107 to have proper standing to bring its claims against entities other than the Debtors, the Trustee and guarantors such that such issue was to proceed at trial. On the

[5] *See* In re Serta Simmons Bedding, LLC, No. 23-90020,2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023).

[6] Pursuant to N.Y. G.O.L. § 13-107, a transferee (i) is not required to demonstrate its own injury to bring a claim for damages and (ii) is expressly permitted to sue for breaches of duties that occur prior to the purchase of the bond, regardless of the bondholder's knowledge of these breaches.

[7] The court also rejected Langur Maize's argument that DTC had standing pursuant to N.Y. U.C.C. § 3-301 (which has typically been applied in the context of nonpayment actions, such as foreclosures) which allows the record owner of a note to sue for payment under a debt. The court concluded Section 3-301 did not apply to a suit for a breach of an indenture agreement and related tort claims because DTC did not experience the alleged harms itself, and thus, could not assign these claims to an entity that did not suffer an injury.

[8] The court concluded Langur Maize properly received authorization to bring its suit in New York state court (and the bankruptcy court court) through a two-step authorization process: (i) DTC, acting through its nominee, Cede & Co., authorized the custodian for the notes to take any and all actions and exercise any and all rights and remedies that Cede & Co., as the holder of the notes, was entitled to take, and (ii) the custodian then authorized Langur Maize, as beneficial owner of the notes, to take any and all action.

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issue of Langur Maize's discounted purchase of the notes, the court concluded such fact was relevant only to the question of whether Langur Maize suffered an injury sufficient for standing purposes and as such, did not decide what effect the discounted price may have had on any damages award.

Conclusion and Take-Aways

The outcome of the continued litigation involving the Transaction will likely implicate Incora's Chapter 11 case and restructuring, as the Debtors' plan confirmation process continues to be pushed out pending the outcome of the litigation. From a broader perspective, this decision is important for majority lenders, minority lenders, indenture trustees and borrowers/issuers as it may serve as a roadmap for minority positions to challenge pre-petition debt restructurings that subordinate or otherwise impair their debt. Indeed, despite the *Serta* decision, both borrowers/issuers and majority lenders considering non-pro rata liability management transactions as in *Incora* should be mindful of the risk that claims brought by excluded/minority lenders may go to trial in both state and bankruptcy courts.

As a result of this decision, indenture trustees should be mindful that, notwithstanding they generally may rely on indenture indemnity provisions to protect themselves from liability, their participation in any such transaction will be subject to scrutiny and their actions may not be absolved solely as having acted at the direction of the requisite number of noteholders.

Finally, holders who are transferees of previously assigned/purchased notes should also be aware that they will be required to satisfy Article III standing in any litigation against parties not expressly set forth in Section 13-107.

ABOUT THE AUTHOR

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Leah Eisenberg is a partner in Mayer Brown's New York office and a member of the Restructuring practice. Leah's practice focuses on counseling clients in default, restructuring, bankruptcy, and corporate trust matters, with an emphasis on indenture trustee and creditor representations. Earlier in her career, she served as a first law clerk to the Honorable Robert E. Gerber, the US bankruptcy judge for the Southern District of New York. Leah has been recognized in The Best Lawyers in America in the fields of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law, and as NYIC Women's Division Executive of the Year Award (2018), among others.