AMERICAN BANKRUPTCY INSTITUTE

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Litigation Round-Up

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CONCURRENT SESSION

2024

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Evaluating and Unraveling Uptier Transactions: Injury, Damages and Available Remedies

I. What is an Uptier Transaction?
   a. A form of priming transaction where a distressed borrow accesses new money from a subset of lenders and/or its sponsor
   b. Debt documents are modified to permit the issuance of "super-priority debt" to a subset of lenders secured by a first lien on the same collateral
   c. Oftentimes providers of the "new money" will have their existing debt exchanged for debt senior to existing debt
   d. The result is non-participating lenders/noteholders are left with debt that is subordinated to the new money debt and the rolled-up debt that was previously pari
   e. Non-participating Lenders go to sleep with a 1st Lien and wake up with a 3rd Lien.
   f. Minority or non-participating lenders have commenced lawsuits against companies, participating lenders, and sponsors, sometimes in multiple jurisdictions, in many cases surviving motions to dismiss
   g. Bankruptcy litigation surrounding these transactions continues to develop as these types of liability management transactions often lead to the borrow filing chapter 11 bankruptcy.
   h. In *Serta*, the Bankrutpcy Court found the "uptier" was authorized under the documents (case is on appeal to 5th Cir); Pending cases include *Incora (Wesco)* and *RobertShaw*.

II. Injury and Harm
   a. Who is an injured party?
      i. Non-participating noteholders who held notes pre-transaction whose rights and claims were adversely affected by the Uptier transaction
         1. Claims against the Debtors and third parties (sponsor, participating lender)
            a. Contract claims under the indenture/credit agreement. Direct claim for breach of contract or third party beneficiary of contract. Also may assert tort claims for tortious interference
         2. Are the claims estate claims? Or direct claims?
            a. Courts look to the nature of the injury and relationship between debtor and injury. Does the aggrieved party's injury flow from the underlying injury to the Debtor?
            b. An estate and a creditor may have a claim against third parties arising from the same facts
            c. *Wesco* Summary Judgment Opinion: Judge Isgur noted noteholder contract claims impaired the holders' secured claims on the assets, not a harm to the assets themselves
            d. Claims for equitable lien or equitable subordination? Are they founded on a fraudulent conveyance or preference theory?

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i. Avoiding the transaction is a fraudulent conveyance claim held by the estate – could result in 510(c) equitable subordination

ii. Who has Standing - Non-participating lenders who purchased notes post-transaction?
    1. Article III standing: (i) injury in fact; concrete harm to a legally protected interest; (ii) causation; traceable connection between injury and defendant's actions; (iii) redressability, can the injury be remedied?
    2. In instances where a holder purchased a note instrument, do the claims travel with the transaction? Are certain claims excluded?
    3. Claims covered by NY General Obligations Law §13-107
        a. N.Y. GOL §13-107:
            i. A transfer of any bond shall vest in the transferee all claims or demands of the transferrer, whether or not such claims or demands are known to exist (a) for damages or recission against the obligor on such bond; (b) for damages against the trustee or depositary under an any indenture under which such bond was issued or outstanding and (c) for damages against any guarantor of the obligation of such obligor, trustee, or depositary
        b. Law automatically assigns transferor's bond claims against indenture parties. (This principle applies to all claims on the bonds, whether they are for non-payment or rescission or whether they relate to ancillary wrongs, such as fraud or misrepresentation). B*luebird Partners, L.P. v. First Fid. Bank, NA*, 91 N.Y.2d 456 (2002).
        c. But §13-107 has its limitations. It is effective only with respect to claims against a defined set of actors enumerated in the statute — an **issuer, a guarantor, a trustee** for the bonds or a depositary to whom the bonds are entrusted. It will not work its magic against other third parties
    4. Claims against third parties
        a. Not covered by N.Y. GOL §13-107
        b. Was the purchaser/holder assigned the claims under an indenture or applicable law? Or does the holder need to show injury in fact?
        c. In *Wesco*, the Langur Maize argued the claims were assigned under a provision of the indenture and no separate assignment is needed. Langur Maize also asserted that DTC cannot authorize holders who are no longer holders to bring a lawsuit. The defendants argued that would be a defense to a suit by the prior holders but doesn't change the fact that only the prior beneficial holder can sue.

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d. Isgur's reaction to evaporation of claims may suggest that claims should survive and be deemed assigned.
e. Was the holder injured by the transaction if it purchased post-transaction, at a discounted price with knowledge of the transaction?
    i. Maybe
f. Do the claims have to be for the benefit of all holders? Something the trustee could pursue? Check the indenture language
g. Only DTC can bring claims and it assigns that rights to the trustee and holders

III. Damages
    a. When do you measure damages? Time of the transaction – Discuss *In re Sanchez*
    b. Factors considered: trading prices, liquidity, harm
        i. Can credit ratings be included as evidence? Hearsay?
    c. Who is the damaged party?
        i. If holders received interest, were they damaged? If so, how is the damage measured
        ii. If unsecured creditors were paid from the new money, were they injured?

IV. Remedies
    a. What does it mean to unwind the transaction? Is that only a fraudulent conveyance remedy?
    b. Is 510(c) the right remedy? Who can pursue it if claimholders have direct claims
        i. If move a claim from unsecured to secured, is that permitted?
        ii. Does 510(c) allow for elevation of priority of certain claims
    c. Value of the lien?
        i. Sanchez and impact transaction had trading prices at time of transaction

V. Sponsors' Protection from Liability - Impact of the economic interest defense
    a. IF you are acting in own self interest, defeats tortious interference claim. How do you prove this?

Draft
Preliminary & Unchecked

Liquidation Discounts and Discounts for Lack of Marketability

Digital Token Examples

Faten Sabry

I. What are the different types of crypto tokens? Do they vary in functions? Liquidity?

a. What Is Crypto? Brief Introduction

i. Crypto currency is a type of digital currency that uses cryptography for security. Unlike fiat money issued by governments, crypto operates on decentralized networks called blockchains.

ii. Crypto assets exist on the internet. A network of computers verifies transfers of crypto assets from one entity to another using cryptography.

iii. Imagine a gigantic ledger that keeps track of all the transactions in crypto, called blockchain.

iv. It is a chain of blocks; each chain is a list of transactions. A blockchain consists of "blocks", or lists of transactions verified by a network of computers.

v. When a new block is verified by the network, it gets added to the blockchain and cannot be altered. This ensures the integrity of transaction history.

vi. Blockchains do not require supervision by a central bank or any other central authority.

vii. It is maintained by a network of computers worldwide which makes the transactions secure.

viii. New coins are obtained by a process called mining.

ix. **Digital wallet is a special place to keep your crypto currency safe.**

x. **To buy or sell crypto assets, users would typically interact with crypto exchanges. Crypto exchanges are like stock exchanges:**

1. **Users can post "buy" and "sell" orders to purchase and sell crypto assets.**
2. **Crypto assets can be bought or sold for U.S. dollar, Euro, other fiat currencies, and other crypto assets.**
3. **Large crypto exchanges typically have several "market makers" providing liquidity to buyers and sellers.**
4. **As of May 5, 2024, the most popular crypto exchanges were Binance (a daily trading volume of $11.2 billion USD), Coinbase ($1.2 billion daily volume), and ByBit ($2.3 billion daily volume), according to coinmarketcap.com.**

b. **Types of Crypto**

i. **Stablecoins : Stablecoins are crypto tokens designed to have a price pegged to a price of another asset. The value of a stablecoin should be stable compared to the value of the underlying asset. Most common stablecoins are pegged to USD. There are stablecoins pegged to currencies, such as Euro, a commodity, such a gold, or other crypto assets, such as Bitcoin. To keep the peg, stablecoins have to keep the reserves of the underlying assets and allow exchanging stablecoins for the reserves on a one-to-one basis or rely on algorithms that adjust the supply of a stablecoin after prices change. Example: Tether USD.**

ii. **Crypto assets, like Bitcoin and Ethereum, are earned through mining.**

iii. **Tokens: A token is a digital asset created and operated on a blockchain that supports digital apps, or "smart contracts." As opposed to Bitcoin or Ethereum, a token can be programmed and then issued by anyone. There is a wide variety of tokens and token types: Some tokens have a limited supply; others are issued over time. Some tokens can be subdivided into smaller parts, others cannot. Some tokens can be freely transferred from one entity to another, others have limitations. Some token values are pegged to the value of other assets, for others the value is determined by the market.**

iv. **NFTs or "non-fungible tokens" are unique crypto tokens that only exist in one copy and cannot be replicated or broken into smaller amounts. NFTs can be associated with a picture, a piece of music, a virtual item in a video game, a land deed in a virtual universe, etc. Since each NFT is unique and their transfers are verified by the network of computers, NFTs can be used to establish and confirm ownership of virtual or real-world item. Most popular NFTs are collectors' items. These are primary picture collections, such as Bored Apes.**

II. **Estimation of the Liquidation Value of a Crypto Asset**

a. **The estimation process is similar to evaluating other financial asset at liquidation.**

i. **Determination of the face value of asset holdings.**

ii. **Estimation of the asset liquidation discount.**

iii. **Estimation of the discount due to lack of marketability.**

b. Liquidity and marketability are two key concepts in assets' valuation, and they refer to the ease with which an asset can be sold without lowering its price.

III. Using Liquidity Discounts to Estimate the Value of the Claim of a Crypto Token in Bankruptcy

a. Damodaran, 2005 "When you buy a stock, bond, real asset or a business, you sometimes face buyer's remorse, where you want to reverse your decision and sell what you just bought. The cost of illiquidity is the cost of this remorse. In the case of publicly traded stock in a heavily traded company, this cost should be small. It will be larger for stock in a small, over-the-counter stock and will escalate for a private business, where there are relatively few potential buyers. … You can sell any asset, no matter how illiquid it is perceived to be, if you are willing to accept a lower price for it."

i. An Apple Stock for example can be bought and sold in a matter of seconds, while it can take a long time to sell a private equity, for example, unless the investor accepts significant price reductions.

ii. The same concept of liquidity applies to cryptocurrencies. They are not all the same.

iii. Measures of liquidity:

1. Trading volume

2. Bid-Ask spread.

3. Depth of the book

4. Price impact from trading

5. Examples of tokens- highly liquid and illiquid.

b. How do you know if an asset is liquid?

i. **Crypto assets vary by liquidity, typically measured by trading volume. Higher liquidity means an asset can be purchased or sold at a current price faster.**

1. **Chart to illustrate large bid-ask, low trading volume, thin market.**
2. **As of May 4, 2024, the most popular crypto assets had high liquidity:**
    a. **Bitcoin: $20.5 billion of daily trading volume.**
    b. **Ethereum: $8.7 billion of daily trading volume.**
    c. **Stablecoin Tether USD: $39.3 billion daily volume.**
    d. **Gnosis had a daily liquidity of $11.9 million.**
    e. **Tether Gold: $2.7 million.**
    f. **HEX: $0.2 million.**

c. **The Liquidation Discount**

i. **If a company with substantial crypto holdings attempts to sell all its holdings at once, there would not be enough buyers willing to buy at current market prices and the company would have to lower the offering price to attract more buyers or selling over a longer period of time.**

ii. **Many academic studies estimate liquidation discounts based of various asset holdings as a function of existing price, volume, turnover, uncertainty of returns, among other factors.**

iii. **The discount is higher as uncertainty about the returns is higher, trading volume is lower, and the liquidation quantity is higher.**

d. **What is a Discount for Lack of Marketability DLOM?**

i. **The DLOM is a discount rate used to adjust the value of an asset based on its overall marketability.**

ii. **Marketability is a spectrum and not an either-or proposition.**

iii. **Example of a non-marketable *digital* asset.**

iv. **For crypto assets, the lack of marketability is usually due to:**

1. **Vesting periods: some crypto tokens can be issued to buyers with vesting conditions. For example, a crypto asset can be sold with a vesting period of one year. This way, the buyer will have to wait for one year after purchasing the asset until they can transfer it or sell it.**

2. **Contractual locks: some crypto assets can be "locked", or "staked" meaning that the owner deposited the asset into a distributed app and the asset cannot be immediately withdrawn and sold. For example, a crypto asset can be used as collateral to borrow another crypto asset. Withdrawing the collateral may require waiting for some time.**

v. **When is it appropriate to apply DLOM?**

e. **Different ways to estimate DLOM for non-marketable assets?**

f. **Using option theory to estimate DLOM – estimate it as a value of a put option. Graph**

i. **The intuition is that if the price of an asset is volatile, the asset holder may want to purchase a put option to be able to sell the asset at an average price over the remaining vesting or locking period as opposed to at the random price at the end of the period.**

ii. An investor can use a put option to get protection from future market fluctuations that might drive the price of the restricted asset down. The price of such a put option should represent the marketability value of the subject asset.

iii. Illustrative Example OF estimating DLOM as a put option. Consider the hypothetical token CoolMonkey.

1. Assuming all hypothetical CoolMonkey holdings of Rocket Ltd. are vested for one year, the discount due to lack of marketability can be estimated using the following assumptions:

a. CoolMonkey is a volatile asset, and its price can decrease or increase over the year until it can be sold.

b. Company X can use an Asian put option to protect themselves from future price fluctuations and sell at an average price over the year before the vesting period ends, if it is higher than the actual price.

c. The price of such an option will reflect the expected loss of value due to lack of marketability of CoolMonkey. It is the price of having to hold the crypto asset for a year while being exposed to uncertainty and price fluctuations.

Faculty

Beth M. Brownstein is a partner at ArentFox Schiff LLP in New York. She has played an instrumental role in many of the country's largest and most complex bankruptcies and reorganizations. Ms. Brownstein is nationally recognized for her work on behalf of secured and unsecured indenture trustees and agents, both in and out of court. She has experience representing creditors' committees, lenders, landlords and strategic purchasers to maximize value and business opportunities in distressed situations. Ms. Brownstein has successfully guided clients through some of the most complex reorganizations filed in the last decade. Her experience spans multiple industries, including hospitality, health care, pharmaceuticals, cosmetics and energy. She is recognized for her work on behalf of indenture trustees and agents in chapter 11 cases such as Hertz, Caesars, PG&E, Intelsat and Mallinckrodt. She also represents trustees and agents in municipal workouts, both in and out of court. In addition, Ms. Brownstein regularly represents creditors' committees, landlords, trade creditors and bridge lenders navigating the challenges of distressed situations. She advises boards of financially troubled companies on corporate governance and fiduciary issues, as well as strategic purchasers acquiring assets of distressed companies. Ms. Brownstein is vice chair of the American Bar Association's Trust Indentures and Indenture Trustees Committee and a member of the boards of the Association of Insolvency and Restructuring Association and the New York Institute of Credit. She also is a member of UJA-Federation's Young Lawyers Division Leadership Committee and NextGen Bankruptcy and Reorganization Group, and she also serves as an ambassador for the Youth Renewal Fund. Ms. Brownstein received her B.B.A. in 2004 with honors from the University of Michigan, her M.B.A. *cum laude* from the University of Miami in 2008 and her J.D. *cum laude* from the University of Miami School of Law in 2008.

Hon. David S. Jones is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Feb. 19, 2021. He handles a varied docket that has included numerous chapter 15 matters, as well as the Revlon bankruptcy and several cases involving aviation and aircraft financing. Judge Jones previously clerked for Hon. Morris E. Lasker, U.S. District Judge for the Southern District of New York, from 1990-92, and was in private practice in New York from 1992-96. From 1996 until he was appointed to the bench, he served as an Assistant U.S. Attorney for the Southern District of New York, and at different times served as the chief of the U.S. Attorney's Office's Tax and Bankruptcy Unit, the Office's chief civil appellate attorney and as deputy chief of the Civil Division. Judge Jones was awarded the Justice Department's Director's Award and the New York City Bar Association's Henry L. Stimson Medal, among other awards. He also served as an instructor at the National Advocacy Center, and as an evaluator of U.S. Attorney's Offices throughout the nation. Judge Jones received his A.B. *magna cum laude* from Brown University in 1985 and his J.D. *cum laude* from Harvard Law School in 1990.

Michael Luskin is a partner at Morgan, Lewis & Bockius LLP in New York. He represents financial institutions in litigation in state and federal courts, including bankruptcy courts, across the country. Much of his work involves enforcing a creditor's rights under the Bankruptcy Code or defending a creditor against "lender liability," fraudulent conveyance or preference claims brought by a creditors' committee or bankruptcy trustee. Mr. Luskin also represents creditors in loan restructurings and out-of-court workouts, and he represents trustees and examiners in cases presenting complex litigation

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Douglas Mannal is a partner in the Business Restructuring + Insolvency Group of Morrison & Foerster LLP in New York, where he focuses his practice on representing clients in chapter 11 bankruptcy cases, out-of-court restructurings and other distressed situations. His clients include official creditors' committees, ad hoc creditor groups and individual asset managers, as well as corporate borrowers. On behalf of creditors, Mr. Mannal implements strategies focused on maximizing creditor recoveries, and he has experience proposing and confirming plans of reorganization, investigating and prosecuting various estate causes of action, negotiating intercreditor disputes, crafting cash-collateral orders, debtor-in-possession/exit financing packages and creditor-sponsored equity rights offerings, challenging confirmation of nonconsensual chapter 11 plans, terminating exclusivity, participating in § 363 sales, and implementing and defending against coercive liability management transactions. On the company side, he counsels borrowers navigating the complex legal, financial and operational issues that arise in distressed situations, implementing both in- and out-of-court restructurings aimed at preserving value. Mr. Mannal has been recognized since 2013 in *Chambers USA*, and *Turnarounds & Workouts* recognized him as an Outstanding Restructuring Lawyer in 2020 and 2017. He also has been recognized as a Leading Global Restructuring Lawyer by *Lawdragon 500*. Mr. Mannal received his B.A. in government and law in 1995 from Lafayette College and his J.D. from Brooklyn Law School in 2000.

Dr. Faten Sabry, APS is a senior managing director and chair of NERA Economic Consulting's Global Securities and Finance practice in New York and chairs its Bankruptcy Practice. She has testified on the economics of distressed-debt exchanges, fixed-income securities, structured products including collateralized debt obligations and asset-backed securities, derivatives, illiquid assets and litigation settlements. She also has consulted on solvency issues, class certification, liability, materiality and damages in cases involving structured products and derivatives. Dr. Sabry has testified as an expert at trial in state and federal courts. Her research has been published in the *Journal of Fixed Income*, *Journal of Structured Finance*, *Journal of Investment Compliance*, *Journal of Alternative Investments*, *Business Economics*, *International Trade Journal* and others. Her publications include a chapter in the latest edition of *The Handbook of Mortgage-Backed Securities*. Dr. Sabry has been accredited as a professional statistician by the American Statistical Association and has been a member of the advisory board of VALCON. She is a member of ABI and the American Finance Association. Dr. Sabry received her B.A. *magna cum laude* and her M.A. from American University in Cairo, and

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