Chapter 11 protections for unsecured creditors are candles in the wind

David Conaway reports on a recent case in the Southern District of Texas which ignores the equality of treatment of general unsecured creditors

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A pillar of Chapter 11 is the equality of treatment of similarly situated creditors. However, in the Chapter 11 Plan of Reorganization of Serta Simmons Bedding (2nd largest US mattress company), confirmed by the US Bankruptcy Court in Texas on 6 June 2023, equality of treatment of general unsecured creditors has been ignored.

A Chapter 11 plan of reorganization (essentially a court-approved contract between the debtor and its creditors) includes "classes" of creditors, such as secured creditors, various priority creditors, general unsecured creditors and equity interests. The Bankruptcy Code requires creditors within each class to be treated equally. In the vast majority of Chapter 11 cases, certain funds are allocated to the general unsecured creditor class to be shared pro rata. However, the Serta Simmons plan treats general unsecured creditors differently, depending on whether or not creditors continue to do business with Serta Simmons, on the same historical terms and conditions.

Creditors who vote in favour of the Serta Simmons plan, and who agree to enter into a trade agreement to continue doing business with Serta Simmons on

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the same terms and conditions provided by the creditor 6 months before the Chapter 11 filing (pricing, credit limits, payment terms, discounts and sales incentives), will receive 100% payment of their pre-petition claims ($120 million). Creditors who do not vote for the plan or do not execute a trade agreement to continue to do business with Serta Simmons will share pro rata in a $5.75 million "pot". The total unsecured claims of this creditor sub-class are estimated to be $30 million, generating an estimated 19% dividend for each creditor's claim.

Strategically, the debtor included the 100% creditors in Class 6A and the 19% creditors in Class 6B. With the majority class voting required under the Bankruptcy Code, the 100% creditors with $120 million in claims not surprisingly voted in favour of the Chapter 11 plan. The 19% general unsecured creditors opposed the Chapter 11 plan such that Class B creditors voted to reject the plan. As a result, the Class B creditors (19%) were a "dissenting" class. The Bankruptcy Code allows for the "cram-down" of dissenting classes of creditors, provided the Bankruptcy Court determines that the plan does not "discriminate unfairly" and is "fair and equitable". The Southern District of Texas Bankruptcy Court approved the cram-down of the 19% creditors. Serta Simmons' creative gerrymandering worked, to the detriment of the 19% creditors.

Creditors with material exposures could have objected to the Serta Simmons plan's classification of unsecured creditors as a violation of the Bankruptcy Code and case precedent, forcing a single class of general unsecured creditors that would be treated the same. If the 100% creditors and the 19% creditors were treated equally, there would be $125.75 million available for all unsecured claims estimated to be $150 million. Each unsecured creditor would receive 84%. The unsecured creditors' committee representing all general unsecured creditors did not object.

In essence, what has happened in the Serta Simmons plan is the Chapter 11 critical vendor standard has replaced the equality of treatment standard, without meaningful due process for the 19% creditors.

In addition, the Serta Simmons plan preserves preference avoidance actions against creditors. However, having received 100% payment, the 100% creditors will be insulated from preference claims. Only the 19% creditors will be at risk for preference claims under the Bankruptcy Code.

However, the 100% creditors are not home free. The plan documents include a template trade agreement with the following: (a) 100% payment shall be in four installments over 1 year after the plan goes effective; (b) if the creditor fails to provide favourable business terms, Serta Simmons can seek disgorgement of the payments to the creditor; and (c) if Serta Simmons fails to pay for goods going forward, after a 15-day cure period, the creditor may terminate the agreement. However, the trade agreement does not provide the creditor can revert to cash before delivery in the event of default. Since the payments to the creditor are for 1 year, a termination for failure to pay by Serta Simmons within 1 year likely means the creditor will not receive further payments. Moreover, it is unclear whether the creditor would have to disgorge payments received. In short, the trade agreement is one-sided, and there are many risks for the 100% creditors that may impact payment. Also, since the trade agreement will be part of the court-approved plan, it is unclear whether there is any ability to negotiate a more balanced trade agreement.

No doubt the Serta Simmons strategy for unsecured creditors will be repeated in future plans by other debtors and will become the customary practice in Chapter 11 cases. In the future, will unsecured creditors be compelled to continue to do business with the reorganized debtor as a condition to any meaningful return? A pillar of Chapter 11 will be eroded to the detriment of unsecured creditors. Serta Simmons is effectively using the Chapter 11 plan process to leverage future business relationships with suppliers, on Serta Simmons' terms.

Perhaps creditors' best bet is on the front-end before a Chapter 11 is filed. Knowing this potential outcome, a creditor needs to proactively manage the customer relationship to have the lowest possible accounts receivable or debt balance in anticipation of a Chapter 11 filing. Focused contract provisions will facilitate the ability to suspend performance or proceed with cash in advance terms. The Serta Simmons plan treatment for unsecured creditors could have the impact of creditors becoming unwilling to support customers who are struggling financially, which the Bankruptcy Code is intended to promote.

As laws fall, I am reminded of Robert Bolt's 1962 play A Man For All Seasons.

"William Roper: So, now you give the Devil the benefit of law!
Sir Thomas More: Yes! What would you do? Cut a great road through the law to get after the Devil?
William Roper: Yes, I'd cut down every law in England to do that!
Sir Thomas More: Oh? And when the last law was down, the Devil turned 'round on you, where would you hide, the laws all being flat? … and if you cut them down, do you really think you could stand upright in the winds that would blow then? Yes, I'd give the Devil benefit of law, for my own safety's sake!" ■

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