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Preferred Equity In Peril?

Two Recent Cases Shed Light on Potential Risks to Preferred Equity Holders in Chapter 11

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Preferred equity instruments have become increasingly popular as a source of financing for private equity sponsors executing large leveraged acquisitions. Investors seeking the risk profile of debt but also the return potential of equity are attracted to the hybrid nature of preferred equity, which generally ranks senior to common equity interests (like debt) and may entitle the holder to common equity-like upside. By law, preferred equity is a varied and flexible instrument, but, in practice, it typically has a limited number of common features. One feature is that the preferred equity is entitled to a "liquidation preference" ahead of common stock. The liquidation preference is typically triggered upon a "liquidation, dissolution or winding up" whether "voluntary or involuntary" and most often equal to a fixed dollar amount per share plus accrued and unpaid dividends to the date of the liquidation, dissolution or winding up.

Whether the liquidation preference of preferred equity entitles preferred shareholders to priority over common shareholders in a Chapter 11 reorganization is a question that figured prominently in two recent high profile cases, *Washington Prime Group, Inc.* and *CBL & Associates Properties, Inc.*, two public REITs (real estate investment trusts) that filed for Chapter 11 due to fallout from the COVID-19 pandemic. In each case, the debtors sought approval of a disclosure statement for a plan that contemplated holders of common stock and preferred stock sharing in a distribution on a 50-50 basis, disregarding the liquidation preference in favor of the preferred stock. In each case, dissenting parties previewed (and in *CBL*, ultimately, prosecuted) objections to the plan on the grounds that the distributions to common stock would violate the absolute priority rule, and in each case, the plan was ultimately confirmed with the application of the absolute priority rule to preferred stock left unaddressed. These cases highlight a risk that the lack of explicit language in applicable governing documents regarding the treatment of preferred equity in a Chapter 11 reorganization could result in parties arguing that preferred equity holders, for purposes of plan distribution, should be treated no better than common shareholders, which may be contrary to the expectations of investors in preferred equity instruments.

CBL and *Washington Prime*: Deathtraps to Avoid Priority Issues

In both *CBL* and *Washington Prime*, enterprise valuation was a prominent litigable issue as a result of the difficulties inherent in ascertaining the effect of the COVID-19 on real property values. Nevertheless, in both cases, the debtors took the position that, under the plan, unsecured claims were not being paid in full, and thus there was no value available for equity under an absolute priority waterfall. This position enabled the *CBL* debtors to argue that providing a distribution

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to common equity when preferred shares were receiving less than their liquidation preference was not a departure from "absolute priority," because the distribution to equity was a "tip," and "the liquidation preference is only applicable where value is otherwise available for distribution to equity holders."

Further, because the absolute priority rule is only implicated with respect to *nonconsenting* classes of impaired creditors and equity holders, the *CBL* and *Washington Prime* debtors devised plans intended to incentivize classes of preferred and common equity holders to vote in favor of the plan. In *Washington Prime*, the debtors proposed a "double death plan" that provided that if the class of preferred stock rejected the plan, there would be no distribution to *either* the preferred stock *or the* common stock, and if the preferred stock accepted the plan but the class of common stock rejected, the distribution that would have been delivered to common stock holders would be delivered to preferred shareholders instead. The details of the *Washington Prime* "double deathtrap" are summarized as follows:

Voting Results	Preferred Stock Recovery	Common Stock Recovery
Preferred and Common Accept	$20 million	$20 million
Preferred Accepts and Common Rejects	$40 million	No recovery
Preferred Rejects and Common Accepts	No recovery	No recovery
Both Classes Reject	No recovery	No recovery

In the initial *CBL* plan, while there was also a deathtrap with respect to each of the common and preferred classes, the deathtrap was a more typical class-by-class deathtrap. Thus, the *CBL* deathtrap left open the possibility that the preferred class would reject the plan and yet the common stock would receive equity of the reorganized debtors.

Ultimately, the deathtrap was removed from both the *CBL* and *Washington Prime* plans, but the debtors' attempts to use deathtraps showcases at least one tool at their disposal to incentivize consent and avoid issues relating to priority vis-à-vis equity holders when valuation is in dispute.

Preferred Stock Under the Old Bankruptcy Act.

The application of the absolute priority rule to preferred equity to the extent of its liquidation preference was addressed in cases decided prior to the enactment of the Bankruptcy Code under Chapter X of the old Bankruptcy Act. In *Central States Elec. Corp. v. Austrian*, 183 F. 2d 879 (4th Cir. 1950), the Fourth Circuit reasoned as follows:

> The 7% preferred stock provides that the holders thereof shall be entitled to receive cash to the amount of the par value and accrued dividends in case of "liquidation, dissolution or winding up of the corporation, whether voluntary or involuntary." We think that, from the standpoint of these stockholders, the old corporation is being virtually dissolved and wound up and that a new corporation is being created as a result of the reorganization. Consequently these preferred stockholders are entitled to the liquidation preference for which their stock provides. *Id.* at 885.

This view was shared by the Ninth Circuit, which held that, unlike unsecured debt, which ceases to accrue interest on the petition date, the liquidation preference of preferred equity continues to accrued dividends under the date of payment. *Petition of Portland Elec. Power Co.*, 162 F.2d 618 (9th Cir. 1947).

The Fourth Circuit's view was met with some resistance from those who argued that courts should focus on the words of the corporate charters, which referred to "liquidation, dissolution or winding up," and proffered that "[a]pplication in a reorganization proceeding of a contract provision that is neither literally applicable, nor intended to be applicable, and whose application operates to the detriment of junior security holders, seems contrary to very basic policies of bankruptcy reorganization." *See* DeForest Billyou, *Priority Rights of Preferred and Common Shares in Bankruptcy Reorganization*, 65 Harv. L. Rev. 93 (1951). Arguing by analogy, proponents of this view note that, in a merger, common stockholders could receive consideration even if preferred stockholders received less than their liquidation preference. This view, however, was not adopted by any court, and the prevailing view of the law under the Bankruptcy Act appears to have been that adopted by the Fourth and Ninth Circuits.

Liquidation Preference Under the Bankruptcy Code: Statutory Interpretation and Gifting Angles

In 1978, Congress enacted the Bankruptcy Code, and the court-made rules about cramdown under old Chapter X were replaced by the statutory provisions of 11 U.S.C. §1129(b). With respect to a class of "interests" (*i.e.*, equity), the Bankruptcy Code provides that a

plan will be fair and equitable as to a class of equity holders, and thus "crammed down" over such class's rejection, if:

> (i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any ***fixed liquidation preference*** to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or
>
> (ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

See, §1129(b)(2)(C).

Some have seen the reference to "fixed liquidation preference" in section 1129 as being the codification of the *Central States* rule. Thus, the House Report issued in connection with the introduction of the bill that became (after reconciliation) the Bankruptcy Code says "[p]referred stock would be an example of an interest likely to have liquidation preference or redemption price." *See,* House Report No. 95–595. Likewise, certain practitioners wrote that in order for a plan to be confirmed over the objections of a class of preferred shareholders and still make distributions to common shareholders, preferred stock must receive "the highest of the preferred's liquidation preference, the redemption price, or the value of the preferred stock." *See,* Chaim J. Fortgang and Thomas Moers Mayer, "Valuation in Bankruptcy," 32 UCLA L. Rev. 1061 (1984).

This interpretation of the Bankruptcy Code was the basis of the *CBL* preferred shareholders' confirmation objection. Specifically, they argued, that by providing common stockholders with a recovery while leaving the preferred shareholders' liquidation preference unsatisfied, the plan violated the absolute priority rule. Responding to the debtors' disclosure statement, which defended the common equity distribution as a "gift," they argued that any such gift would be an impermissible "vertical gift" — *i.e.*, a class-skipping gift that is proscribed by certain judicial authority.

The *CBL* debtors, however, challenged the assumption that the preferred stock should benefit from the absolute priority based on a narrow textual interpretation of the Bankruptcy Code. First, the debtors argued that the absolute priority rule only applied if the class of interests was "entitled" to a "fixed liquidation preference." The debtors argued that there was no *entitlement* to a fixed liquidation preference in the context of the *CBL* restructuring because the liquidation preference of the *CBL* preferred stock only applied to a "liquidation, dissolution or winding-up," which was the same argument made by opponents of the pre-Code *Central States* case.

In addition, the debtors cited the second prong of section 1129(b)(2)(C) as an additional line of defense. Specifically, the debtors argued that no distribution was being made to a "junior interest" because the common stock was junior in a liquidation only, not a reorganization, for the reasons stated above. Finally, the debtors argued that, because there was no absolute priority issue, there was no issue of "vertical gifting." Rather, the common/preferred distribution could be justified as a "horizontal gift" from one out-of-the-money class (the preferred) to another (the common), which many courts have permitted.

In the end, however, the *CBL* court did not address the parties' absolute priority arguments. Rather, because the preferred shareholders accepted the plan, the court held that the absolute priority rule was not implicated.

Lessons Learned

Washington Prime and *CBL* reveal that a liquidation preference that is silent as to Chapter 11 reorganizations may expose preferred shareholders to risk that they will be forced to share a bankruptcy distribution with common shareholders. In *CBL* and *Washington Prime*, the issue was a marginal one given the limited value available to such classes. However, in a case where the preferred shares are the evident fulcrum, the issue could be consequential.

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