TalkingPoint: Trends In US Bankruptcy

December 2013

FW moderates a discussion on current trends in US bankruptcy between Angela Ferrante, vice president of Bankruptcy Operations at The Garden City Group, Inc., Richard G. Mason, a partner at Wachtell, Lipton, Rosen & Katz, and Margot B. Schonholtz, a partner at Willkie Farr & Gallagher LLP.

FW: Reflecting on the last 12-18 months, how would you characterise the US market in terms of the failing businesses and bankruptcy filings?

Ferrante: This raises an interesting distinction between businesses in distress and those which seek bankruptcy protection. In the past year and a half, as we continue to suffer through a rocky economy, many businesses have experienced trouble. Just this year, we facilitated an out of court restructuring, which involved a rights offering. Although the company failed to attain adequate participation, the company eventually consummated the offering in a pre-packed bankruptcy. In contrast, during the 'bankruptcy boom' period – which appeared to slow after the bankruptcies of such giants as GM and Lehman Brothers – many lenders found themselves in the position of credit-bidding on their secured claims. Perhaps in part to hindsight being 20/20, lenders appear to be more willing to 'amend and extend' their terms of financing, which has in turn provided companies with alternatives outside of bankruptcy.

Mason: Overall, the level of business failure in the US has slowed over the last 12-18 months. Given the low interest-rate environment maintained by the Federal Reserve, large businesses in particular have been able to refinance their debt, often with new financing that is 'light' on covenants tied to business performance, in a 'kick the can down the road' strategy. Whereas in 2009 there might have been 25 or 50 large scale bankruptcies and restructurings, today there are only a handful. But many of the companies that have used refinancing to defer their issues, will still face those issues if – or when – rates go up.

Schonholtz: There has been a downward trend in US business bankruptcy filings during the last four years, and business bankruptcies are down about 30 percent so far in 2013 compared to where they were at this point in 2012. Companies are continuing to buy time via 'amend and extend' arrangements with respect to their existing financing arrangements. Companies which ultimately will need balance sheet restructurings are paying fee-hungry lenders for the best extension they can get instead of tackling a true restructuring. Lenders have also been permitting dividend recapitalisation deals – where equity owners use third-party financing to pay themselves significant dividends – and payment-in-kind interest financing in volumes we have not seen since before 2008. The dividend recapitalisation deals will likely be scrutinised and may become the subject of litigation during the next significant bankruptcy cycle.

FW: Are any particular sectors demonstrating structural weaknesses, resulting in more restructurings?

Mason: Yes, notwithstanding the low-interest environment in which we are operating, several industries are distressed. Energy producers whose end-prices are tied to natural gas, are seeing much lower operating margins due to the discovery of massive shale gas reserves and the corresponding drop in natural gas prices. A number of them are, or soon will be, facing liquidity and financial covenant issues. Falling commodity prices, and stricter environmental regulations, have also pressured coal miners. And while we don't think of government as an 'industry' in the traditional sense, municipal governments, such as Detroit, have had to deal with a declining tax base, and pension and healthcare liabilities that they find increasingly difficult to afford.

Schonholtz: Heavily unionised companies and municipalities are under stress due to the high cost burden and extreme difficulty of modifying labour agreements and retiree benefits outside of bankruptcy. The confluence of these and other pressure points in the coal industry has necessitated financial relief. Coal companies are contending with downward price pressure driven by the low cost of alternative energy sources and weakening demand, lack of support from politicians who favour alternative energy sources, and increased regulatory and environmental compliance costs. Healthcare is another challenged industry, particularly on the provider side – hospitals, long term care, doctors, and so on – where Congress and local governments are trying to rein in Medicare and Medicaid costs. We anticipate an increase in financial stress on healthcare providers as the Patient Protection and Affordable Care Act, a primary focus of President Obama's agenda, is phased in.

Ferrante: In a literal sense, municipalities have been a subject of discussion, where you actually see crumbling infrastructures, as in the Jefferson County, Alabama bankruptcy, which was triggered in part by an overhaul of the county-owned sewer system. Municipalities have also been suffering from ever-mounting legacy pension costs, which is a symptom exhibited by many industries, past and present. The Detroit bankruptcy – the largest municipality bankruptcy in history in terms of both debt and municipal population – was further exacerbated by increasing bond yields, declining population and a drastic loss of tax base. When considering the influence these 'isolated' incidents of financially crippled local governments have had on their communities, one can only guess what impact a prolonged national governmental shutdown might have on individuals, small businesses and entire industries.

FW: To what extent are troubled companies able to refinance and renegotiate existing debt structures in the current market? Are banks relatively supportive in distressed situations?

Schonholtz: The 'kick the can down the road' strategy – amend and extend – is alive and well. Lenders are relatively supportive of renegotiating their existing credit arrangements, particularly for generous fees, and higher interest rates in some cases. Due to extensive liquidity in the financial markets, companies can also raise additional capital, enabling them to limp along until their next major maturity date. When companies breach the financial covenants in their financing agreements, it is often an early warning sign of financial distress. However, for a variety of reasons, lenders will often loosen these covenants. Companies that encounter an 'external' event like a major litigation, government investigation or patent loss often run out of time before they can reach a consensual arrangement with their lenders. At that point, it may be too late for the company to get the financial resources it needs without a Chapter 11 filing.

Ferrante: Relatively speaking, banks are supportive in today's market. Lenders often find themselves in the position of either financing the bankruptcy, due to a lack of other alternatives, or find themselves credit-bidding on their undersecured claims. Like any other financial institution, banks have metrics in place to determine what would be their best course of action. However, it's rare that other lenders will be willing to provide financing to a company once it's sought bankruptcy protection. Luckily, the bankruptcy process allows a company to clean up its ledger and clear itself of burdensome liabilities, making the uncertainty of continued involvement more palatable.

Mason: Although the credit markets received a jolt this summer when Fed officials indicated a timeline to wind down the Fed's bond-buying program, by August the market seemed to have largely recovered, allowing many below-investment grade companies to refinance or renegotiate their debt with relative ease. The strategy of 'amend and extend' has become popular for companies and creditors who believe that pushing issues off into the future is better than causing a contentious restructuring or bankruptcy now. Similarly,

when companies have tripped over covenants in their debt agreements, the lenders have generally been more amenable to granting waivers – for a price, of course.

FW: What methods are creditors in the US using to assert their claims against insolvent debtors and recover as much value as possible?

Ferrante: Often, a creditor's best strategy will depend on the type of case and the creditor's position. Notwithstanding, more times than not, the most efficient approach to a creditor realising its claim may be to work with the debtor in its restructuring. In turn, courts have recognised the value in this relationship, and have routinely approved motions which seek to pay what are commonly referred to as 'critical vendors' and authorise plans of reorganisation which provide beneficial treatment of such vendors' claims which arose prior to the bankruptcy filing. It's usually best for a creditor to take pause and not immediately focus on just its accounts receivable but, rather, take a long-term view of its relationship with the debtor.

Mason: Creditors in litigious insolvency situations typically band together to obtain a 'blocking position' so that a reorganisation cannot be approved and implemented without a substantial fight. Their goal is often to take ownership of the company through its debt. Additionally, creditors in a secured position, might condition their financing on the debtor agreeing to put itself up for sale quickly, perhaps to the creditors themselves in a credit-bid. Original lenders such as banks, usually want to recover as much of their debt as possible in cash, as soon as they can. But hedge funds, which are active participants in restructurings, will often be very comfortable with this type of 'loan to own' strategy.

Schonholtz: In recent years, there has been a return of the use of 'roll-ups' to entice existing secured lenders to provide debtor-in-possession (DIP) financing. In doing so, existing lenders are able to transform prepetition secured claims into post-petition, superpriority claims. We are also seeing debtors receive multiple offers for DIP financing from parties at various levels of the capital structure, including secured lenders, bondholders or other investors pursuing a 'loan to own' strategy. Distressed investors typically look to acquire debt in multiple places in the capital structure when it is unclear at the outset exactly where the fulcrum security will be or where it will be helpful to influence plan voting in relevant classes. Creditors have also been pushing to reach consensual restructuring deals prior to a company's bankruptcy filing in hopes of reducing the duration of the bankruptcy and lowering the administrative costs of the process.

FW: What themes are you seeing in bankruptcy related disputes and litigation, and how are they affecting the process?

Mason: Recently, litigants have added to their 'toolbox', the push for a court-appointed examiner to investigate the company's pre-bankruptcy transactions. In a large complex Chapter 11, such an appointment can add tens of millions of dollars in costs, and many months of delay, to the case. This is particularly true if there have been allegations of insider transactions between the debtor and its parent company or affiliates. The examiner will usually produce a detailed report, which the parties might use as a basis for settlement. Occasionally, they might even use the threat of an examiner, to create or enhance settlement value.

Schonholtz: There is a proliferation of litigation in today's bankruptcies against both traditional and more novel defendants. Creditors' committees and large creditor groups have tried to find new ways around the Bankruptcy Code's safe harbour provisions which have historically protected shareholders, financial participants and other parties in their prepetition transactions with companies. To recover more value for creditors, committees and litigation trustees continue to use fraudulent transfer and preference litigation to try to recover money from all parties that received value from the estate before the bankruptcy, no matter the size of the claim. In the past, it was cost-prohibitive for estates to file preference actions against parties which had received small transfers from the estate. Technology has made it much easier and more cost-effective to analyse and pursue these claims, and we are seeing many more preference lawsuits.

Ferrante: It's not uncommon to see fraudulent conveyance actions brought against lenders in the wake of bankruptcies which follow leveraged buy-outs. Notably, the Eleventh Circuit Court of Appeals, in In re Tousa, Inc., last year found certain lenders liable for over $400m as a result of an LBO which occurred prior to the bankruptcy. At the end of a three year appellate process, the Circuit Court agreed with the Bankruptcy Court's 2009 decision that held that the corporate subsidiaries in question did not receive 'reasonably equivalent value' when they encumbered their assets to secure a loan made to them and their corporate parent to facilitate the LBO. Some might say this decision has had a chilling effect on lenders participating in some of

the riskier LBOs. Specifically, because bankruptcy law incorporates state fraudulent conveyance law to a certain extent, LBOs that occurred as many as six years prior to the bankruptcy risk being undone and the lenders held liable.

FW: To what extent are creditors bringing post-bankruptcy claims against D&Os? Are such claims generally successful?

Schonholtz: Disgruntled creditors are likely to target whoever they can, especially where they feel they have a high chance of a monetary recovery. Creditors' committees often choose to pursue causes of action against a company's directors and officers because they are assumed to be closest to the decisions that led to a company's failure and because D&O liability insurance usually exists as a source of recovery. In recent years, we have seen the filing of many claims against directors and officers for breach of fiduciary duty and breach of duty of care. Plaintiffs suing on behalf of estates – creditors' committees, litigation trustees, and so on – are now requiring directors and officers to contribute to global settlements with other defendants. A related trend is the increasing difficulty of obtaining plan releases for directors and officers. These releases are frequently contested, and many bankruptcy judges are heavily scrutinising and narrowing releases even in consensual plans.

Ferrante: D&O claims can become sizable assets in bankruptcy. To prosecute them, typically a trust is established and funded under a plan of reorganisation, much the same as for other causes of action which the debtor may pass through to its creditors in bankruptcy. The costs of litigating such causes of action may be prohibitive, given that officers and directors are usually indemnified under the D&O policies and their defences paid for. However, it's rare that viable D&O claims will be a part of a successful reorganisation. Nevertheless, the threat that D&O claims may be brought can be used as leverage in creditor negotiations.

Mason: In today's contentious restructuring environment, directors and officers often become the targets of litigation. The complaints might centre on a particular transaction that they approved prior to the bankruptcy filing, or, more generally, their alleged responsibility for the overall demise of the business. If the directors and officers did not obtain a release in the bankruptcy, then this litigation might continue for years after the company has emerged. While it is difficult to generalise in this area since the issues are so fact-specific, the corporate law in the US provides a large measure of protection for directors and officers who make decisions for troubled companies in good faith, and thus efforts to hold well-advised D&Os personally liable, have usually been unsuccessful.

FW: What trends are you seeing in cross-border or multijurisdictional insolvencies? What additional challenges do such engagements present?

Ferrante: We truly operate in a global economy. As an illustration, the retail industry has gone through immense change in the last 10 to 20 years, with manufacturing rapidly moving overseas. It's almost impossible to imagine a large-scale bankruptcy proceeding today without an international component to it. In a broader sense, such insolvency proceedings present challenges involving which country's laws will be recognised as governing certain aspects of the proceedings. In some instances, self-help is recognised as a remedy against an insolvent company, in which case you may experience condoned looting of the estate's assets. In another sense, as the trustee in the Madoff proceedings found, service of process can take up to years to effectuate overseas, at which point any recoverable assets may have already been tapped.

Mason: Given the international scale of business today, it is very common for restructurings to have a cross-border element. Chapter 15 of our Bankruptcy Code, and similar statutes in other jurisdictions, try to harmonise the often conflicting insolvency regimes in the countries where a debtor operates. But beyond the pure legal issues, the marriage of US restructuring norms, and those of other countries, is often not a pretty one. For example, in the US, many creditors, such as hedge funds, have a 'loan to own' investment thesis. Elsewhere, banking institutions might be more desirous of keeping the company's debt structure in place. Reconciling these fundamentally different perspectives can be very challenging.

Schonholtz: International insolvency law has had a strong period of development in the eight years since Chapter 15 of the Bankruptcy Code was enacted. Courts have provided useful interpretive guidance and practitioners in the US and other commercially sophisticated jurisdictions have gained a great deal of practical experience in managing complex cross-border insolvency cases. Recently, the Second Circuit recently articulated a cogent and flexible standard for determining a Chapter 15 debtor's centre of main interest

(COMI). In In re Fairfield Sentry Ltd., the first Second Circuit decision to address recognition issues under Chapter 15, the Second Circuit held that a debtor's COMI should be determined as of the time of filing of the Chapter 15 petition and not during the debtor's entire operational history. In the years to come, we can expect that courts will provide more clarity in the Chapter 15 area.

FW: How do you expect US restructuring and bankruptcy activity to unfold for the remainder of 2013, and into next year?

Mason: In the short term, as long as interest rates are low, most troubled companies will be able to refinance their way of their pressing problems, and restructuring activity overall will remain at a subdued level. But in the meantime, middle market companies that have limited access to the credit markets, and larger companies whose problems are too difficult to defer or ignore, will need to restructure. And once rates start to climb back up, the marginally healthier companies – particularly those with maturing debt – will need to face their issues, which might be even larger at that time than they would have been if they had been dealt with today.

Schonholtz: Given higher capital reserve requirements and other developments affecting major financial institutions, traditional lenders – and even administrative agents – are increasingly selling down or selling out their positions to distressed investors earlier than we have seen in the past. Therefore, distressed investors are becoming the most influential constituents at earlier stages in restructurings and bankruptcies. Companies with short liquidity runways that cannot raise new financing will be using asset sales as a way to shore up capital to extend the runway before a bankruptcy. We are going to continue to see fewer bankruptcies in the near future as more amend and extend deals get done. In circumstances where bankruptcy is unavoidable, we anticipate that companies will do everything they can to enter Chapter 11 proceedings with a pre-negotiated or pre-packaged plan embodying restructuring deals or asset sales agreed to by the major creditor groups prior to the filing.

Ferrante: Like so many things, bankruptcy activity is pendulous and, at the moment, filings are trending downward. However, restructurings continue to take place outside of court and the bankruptcy process. Professionals are continuing to develop new products and services, as we hope the economy improves. As the economy improves and interest rates increase, stronger companies will thrive as less viable ones will be unable to attain financing and will require restructuring. As 2013 nears its conclusion and we head into the new year, we expect to continue to provide value to our clients and to prepare them for the changing economy ahead.

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