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Freeborn & Peters LLP

ROUNDTABLE

US BANKRUPTCY

A tight credit market, reduced consumer spending and rising oil prices are fuelling an increase in US corporate bankruptcies. Almost all sectors are under pressure and many businesses are assessing turnaround options. Formal restructuring processes under Chapter 11 are being weighed against out of court solutions. Effective restructuring requires management of existing creditor arrangements, maintaining an efficient workforce and raising capital to fund the plan. A weakening economy has intensified these challenges, and the number of troubled companies is expected to increase in the coming months.

www.financierworldwide.com

FW MAGAZINE

REPRINTED FROM

Financier Worldwide July Issue 2008

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Sprayregen: How would you describe the US bankruptcy market over the last 12 to 18 months?

Kinel: The market has been extremely turbulent during this time period, as we have seen the numbers of both business and consumer filings rise significantly. The total number of Chapter 11 business filings in May 2008 was 46 percent higher than in May 2007. Businesses have been hit hard by the combination of a tight credit market, a decrease in consumer spending, seemingly ever increasing oil prices and the continued deterioration of the housing market. We are also beginning to see something that we haven't seen in a long time: municipal bankruptcy filings, notably the City of Vallejo, California. I expect these trends to continue throughout this year and for the foreseeable future.

Caruso: The bankruptcy market has clearly accelerated over the past 12 to 18 months. The first quarter of 2008 saw almost 9000 business bankruptcies – an almost 40 percent increase from the comparable period in 2007. However, not all of these cases just emerged as problem credits. Many of them have had signs of stress two or three quarters earlier. The bankruptcy filings are the manifestation of either the implementation of the work done in those prior periods or the complete breakdown of unsuccessful efforts. It is likely that many of the cases lack sufficient size or complexity to justify an adviser's services and the number is overstated due to multiple debtors. Even with the increase to date, I believe the level of activity is still below anticipated levels and the surge in cases has been pushed out to 2009.

Hammer: Despite the initial drop in bankruptcy filings following US bankruptcy reform, commercial bankruptcy filings jumped substantially over the last 12 to 18 months. Business bankruptcy filings rose by 40 percent during the 12 month period ending in March 2008, as compared to the previous 12 month period ending March 2007. Whereas in recent years the types of businesses that filed for bankruptcy post-reform period were comprised mainly of subprime lenders and Tier 1 and Tier 2 automotive suppliers, the number of business bankruptcy filings in the housing, retail and manufacturing sectors, has grown exponentially over the past 12 months. These numbers directly reflect the general economic malaise in the US.

Glass: We have seen a significant increase in the turnaround consulting and distressed management business over the past 12 to 18 months, particularly in real estate. Early on in this current cycle the weaker players were affected, however, now most participants in the residential single family and condominium markets, including A-plus companies are having some level of difficulty. Some of the early signs of the current downturn included a shortage of additional collateral to be provided to lenders and creditors. The extreme financial leverage of the first part of the decade has left many companies with very little dry powder to affect a workout or restructure. This high leverage is one of the factors that have accelerated the downturn.

Linstrom: Bankruptcy filings are growing, particularly in the retail sector. As examples, Bombay Furniture, Sharper Image, and Linens N Things have filed Chapter 11 cases in the last six months. One of today's clear trends in the retail sector is that troubled retailers are not finding the incremental financing necessary to achieve a turnaround. Senior lenders have much less patience with poor performance and no other lenders are ready to step in – a dramatic change from one year ago. The credit markets for troubled retailers have shut down and the same is true for the homebuilding industry.

Butler: The number of US bankruptcies has been growing at a slower pace than anticipated. However, the volume of mid-cap Chapter 11 reorganisations has been increasing as market liquidity has been tightening. There have been relatively few large-cap Chapter 11 reorganisations filed over the last 18 months and most of those filings have involved companies that were selling their assets or liquidating as opposed to actually reorganising. We expect that may change over the next six to 18 months if market liquidity does not improve. That said, there is a substantial amount of out of court restructuring activity across all market-cap tiers.

Sprayregen: Could you outline the primary macroeconomic trends currently affecting businesses?

Schnelling: Inflation, recession, weakened dollar, weak US credit markets, weaker job outlook and continuing globalisation are the major trends currently dragging the economy down. Interestingly, we could easily see a return to the days of 'stagflation' where both a recession rages in the country and inflation runs out of control.

Hammer: US gross domestic product growth, while still positive, has fallen for several straight quarters and may turn negative by the next quarter. Meanwhile, inflation is rising, primarily due to record high oil prices, which have affected the cost of food, transportation and manufactured goods. Some economists predict that the US economy may be heading towards a period of 'stagflation' that has not been experienced since the early 1970s. Certainly, inflated commodity prices have put tremendous pressure on US businesses, which must raise prices simply to stay afloat. And the risk of stagflation also presents a monetary policy dilemma, since a reduction in interest rates – which should provide businesses greater access to liquidity – stands to compound the current inflation problem.

Glass: On a macroeconomic basis there are many factors that are contributing to or even fuelling the current crisis in the domestic market. These include the weakness in the US dollar, rising fuel costs and the drying up of the credit markets. In addition, there has been a general loss of trust and credibility in much of the underwriting in the public real estate debt market. We have just lived through an extreme period of increased valuations and growth in the US economy. It is not surprising that the breaks have been put on and the market has slowed.

Caruso: One of the biggest questions involves the potential for a US recession and how deep and devastating that recession becomes. To the extent that the US slides into a recession and to the extent that that recession is broader and deeper than past recessions, bankruptcies will obviously increase. Some scenarios for a 'hard landing' of the economy would indicate defaults into the mid-teens up from 'soft landing' estimates in the range of 5 percent. An ancillary issue is the degree to which the global economy has decoupled from the US economy. US businesses will be further hurt if exports cannot save them – dollar exchange rates will be a factor. In addition, it remains unclear when the credit markets will reopen to finance the ordinary course of business and refinancings.

Butler: The dramatic rise in the cost of commodities and expected inflationary pressure is driving consumer behaviour to reduce dis-

cretionary spending across virtually all business sectors in the US. Furthermore, Wall Street has not worked through the effects of the subprime mortgage crisis and the capital markets are choppy, at best. While nobody has the perfect crystal ball to predict how this will all turn out, one of the likely outcomes is that restructuring activity should be robust through the end of the decade.

Linstrom: We are seeing consumer financial stress manifest itself in trouble for the automotive industry and trouble for the retail sector. Consumer purchases of automobiles and light trucks have dropped substantially, leading to increased financial stress for all firms supplying the automotive sector. Retailers, with the exception of a few major discounters like Costco, are likewise seeing disappointing same store sales numbers in 2008, hurting their ability to meet earnings targets for 2008.

Kinel: As we all read in the newspaper every day, weakness in the housing market, inflation, previously unimaginable gas and energy prices, the shrinking value of the dollar, the collapse of the subprime debt market and the resulting tightness of credit are all trends currently adversely affecting businesses. Companies are facing a very difficult financing environment, and few business segments will be immune to the effects of these developments.

Sprayregen: Which sectors are demonstrating structural weaknesses? Can these problems be resolved through bankruptcy and restructuring processes?

Butler: Almost all business sectors in the US are impacted by current economic problems. However, manufacturing businesses with a special emphasis on rust belt industries like the automotive sector are likely to suffer most. Technology manufacturing businesses are faring somewhat better but are not immune to commodity price increases, inflationary pressures and reduction of consumer discretionary spending. Retailers are also feeling the pressure. In terms of resolving such issues, Chapter 11 reorganisation is a tool for restructuring professionals but never the end game or even the preferred approach. Much of the action at the current time continues to be outside of the courtroom in strategic restructurings that are occurring apace across market cap tiers and business sectors.

Linstrom: The sector showing the most weakness is the consumer mortgage sector. There is not much bankruptcy can do here other than facilitate 363 sales of loan portfolios or complete debt for equity swaps under a Chapter 11 plan. The real fix requires that the industry go back to historical underwriting standards and stop making loans to consumers that make no sense.

Hammer: Record high oil prices are affecting US industries across the board, but transportation, particularly aviation and automotive, has demonstrated the greatest current structural weaknesses. While airlines have been forced to undertake creative approaches to increasing revenue and cutting expenses in the face of unprecedented fuel costs, automobile manufacturers and their suppliers, still burdened with staggering legacy costs, have experienced plummeting sales of their most profitable products. Bankruptcy and restructuring may allow these industries to address legacy cost issues in the short term, but continued oil price volatility will likely ensure that these industries face significant foreseeable future challenges.

Schnelling: The sectors most affected are airlines, automotive, homebuilding and retail primarily in mid end goods – boats, cars, housing products, cycles – being marketed to the middle class which is the most under pressure due to energy, food, education costs and mortgage price problems. These are truly macro problems that are relatively intractable at the micro level and don't lend themselves to fixing through restructuring and bankruptcy except to the extent that these tools take real capacity out of the system.

Chapter 11 reorganisation is a tool for restructuring professionals but never the end game or even the preferred approach. Much of the action at the current time continues to be outside of the courtroom in strategic restructurings.

JOHN (JACK) WM BUTLER, JR.

Glass: Some of the hardest hit industries or business segments are automotive, airline, transportation, real estate development and housing. Some of these industries will not recover for some time. In the case of residential real estate there is an unbelievable over supply in markets such as Florida, Georgia, California, Nevada and other states that have been hard hit by the downturn. One industry that we believe is getting ready to be hit very hard is retail. Retail will be the next frontier where lack of consumer confidence and disposable income come together for the next storm. In most cases it is a case by case analysis but some of the current situations cannot simply be worked out through a bankruptcy. Some of the industries in trouble are fundamentally broken and a bankruptcy cannot solve the way the industry operates.

Kinel: Some of the sectors that are currently under the most pressure are retail, transportation, manufacturing, healthcare, construction, mortgage lending and financial institutions affected by the subprime fallout. Industries that rely heavily on borrowed money to finance their operations or are highly dependent on oil have been hit particularly hard. Unfortunately, bankruptcy is not necessarily going to solve companies' problems in the current credit environment, particularly with lenders declining to make or increase the size of their loans. We have recently seen a lot of companies filing for Chapter 11 protection only to end up being quickly liquidated because they are unable to obtain debtor-in-possession (DIP) or exit financing to fund their operations. Until the credit markets become more receptive, the bankruptcy process may be of limited help to cash poor companies.

Caruso: The catalyst was the credit crisis in mid-2007, which resulted in de-leveraging. The financial sector, including commercial/investment banks and monolines, was significantly affected. This distress spread to other sectors like homebuilders. Furthermore, commodity price inflation has exacerbated the situation. Think about attaining equilibrium in the economy on an input/output basis — increased oil prices, increased resins and energy prices, potential slowdowns in GDP, decreased disposable income, impacts on consumer sectors. This transmits minatory

signals to a multitude of sectors over a few quarters. If these problems can be solved through the restructuring process, they will be determined on a case by case basis. In some cases, the most important factor will be exogenous to the restructuring process.

Sprayregen: As business conditions deteriorate, what do directors need to keep in mind regarding their fiduciary duties and the issue of deepening insolvency?

Linstrom: Directors must, first and foremost, focus on maximisation of value for all stakeholders. If they can demonstrate a commitment to having done so, they should have no problems. It will be a very rare case where director liability results from having made prudent decisions, which can be unassailably demonstrated as in the best interests of stakeholders. Directors are advised to hire restructuring professionals early into a problem. The trouble arises from letting a problem get too far down the road towards insolvency without the benefit of critical advice from restructuring lawyers and financial advisers. This is particularly true in today's environment where lenders are taking action on troubled borrowers much faster than they did before the credit crunch hit. The stunning speed with which Bear Stearns' problem forced a transaction should show all directors that the time to act is when problems first become apparent.

Butler: While directors have duties of loyalty, good faith, and care to shareholders, there are no such duties owed directly to creditors of a company unless it is actually insolvent; rather, the obligations to creditors are contractual and defined solely by the debt documents. When a company finds itself in financial or operational distress, the development and consideration of strategic alternatives takes time. It is not uncommon in situations where a company is facing a severe liquidity crisis for its existing lenders to provide short term, interim, bridge financing designed to afford the company a breathing spell while it works with its stakeholders to develop a restructuring plan that avoids bankruptcy. Unfortunately, some courts have held directors and officers subject to liability for the firm's 'deepening insolvency' premised on the notion that anyone who may have prolonged a financially troubled corporation's operating life, thus further depleting the corporation's assets and increasing its exposure to creditors, may be liable to the corporation and, derivatively, to creditors and shareholders for any resulting loss. Fortunately, most courts require a showing of wrongful conduct such as fraud as an element of a claim for deepening insolvency. Recently, influential courts in the US have rejected the notion that an independent tort for deepening insolvency should be recognised or that it is an appropriate measure of damages in breach of fiduciary duty cases.

What directors need to be aware of is that their duties and obligations may migrate to beyond shareholders to include other constituents – financial creditors, trade creditors and possibly others. This is sometimes a difficult transition for board members to make.

VICTOR G. CARUSO

Caruso: From a legal standpoint, it is imperative that both internal and independent directors understand and fully appreciate their obligations. What directors need to be aware of is that their duties and obligations may migrate to beyond shareholders to include other constituents – financial creditors, trade creditors and possibly others. This is sometimes a difficult transition for board members to make. The difficulty of the transition may be exacerbated in matters involving financial sponsor portfolio companies and closely held corporations.

Glass: The ever present risk for the directors is that at some point in a troubled companies life cycle they become insolvent. At that time the directors are essentially working for the benefit of the creditors. This can be a difficult concept for some directors. We are aware of many situations where sophisticated directors are inviting bankruptcy counsel in to make presentations to fellow board members. Furthermore, directors need to thoroughly understand the extent of their personal liability.

Schnelling: Directors must consider the same things they always had to consider – a prudent approach to reviewing conditions in the businesses they direct, attention to lengthening payable cycles and perhaps a heightened awareness of the pressures on creditors to prevent the company from getting in too deep. Deepening insolvency is a developing area of the law and while it is always good to be aware that your company should try to avoid decisions which make its situation more troubled lawyers need to be consulted regularly to make sense of this changing area of the law for directors.

Kinel: A number of recent decisions have cast serious doubt on the legal foundation of the deepening insolvency theory, holding that it is not an independent cause of action and that the wrongs the deepening insolvency theory seeks to address can be pursued through traditional legal actions such as tort, fraudulent conveyance, preferential transfer or private federal securities claims. Even though some courts appear increasingly sceptical about the doctrine of deepening insolvency, as always directors need to steer clear of conduct that may fit within traditional tort theories of liability that come into play when a company enters the zone of insolvency.

Hammer: While the theory of deepening insolvency recently has been battered by several federal circuit court decisions sharply criticising the validity of this cause of action, directors still must remain aware of their fiduciary duties to creditors when the enterprise enters the zone of insolvency. Undoubtedly with the deteriorating US economy, activist creditors of an insolvent enterprise – and their creative lawyers – will investigate their options for recovery, whether through the company itself or through its directors. Directors of a company in, or nearing, the zone of insolvency should continue to take great care in contemplating future actions, paying close attention to their potentially shifting fiduciary duties, and relying on the advice of their most trusted restructuring advisers.

Sprayregen: Do you believe the prevalence of PIK toggle and covenant-lite loans issued during the last M&A boom will delay the onset of a bankruptcy wave?

Glass: Contrary to what some people believe, we do not think that covenant-lite loans will delay the onset of a bankruptcy filing. Some of these loans have been poorly monitored compared to the more traditional loans. Either way covenant-lite or traditional loan covenants, the borrowers breach of the payment schedule or other financial requirements is what is going to drive the process. Some of these covenant-lite loans have already been restructured and on the first pass have been amended to include more traditional requirements.

Linstrom: PIK toggle and covenant-lite loans will to some extent cause delay, but it depends on the capital structure of the borrower. If the debtor has senior loans with covenants, then they could be tripped even when the junior debt without covenant protection is not triggered. The option to pay with securities instead of cash will certainly reduce potential liquidity problems for many borrowers.

Kinel: These types of loans probably have delayed or prevented some bankruptcies by, for example, allowing companies to conserve cash by making interest payments by issuing additional debt. Such steps may obscure companies' financial weakness, however, and it is likely that, for some, these types of loans will not be enough to stave off bankruptcy altogether. Investors are concerned by the steps certain companies have taken, pushing down the prices of PIK toggle bonds and other debt with looser terms, such as covenant-lite loans. Accordingly, going forward I would expect that the market will see more traditional structures, including lower debt multiples and full covenant packages.

Hammer: PIK toggle and covenant-lite loans may delay the onset of bankruptcy for borrowers that have loans with these features, while at the same time masking deeper financial distress and, thus, causing a greater long term deterioration of enterprise values than in previous economic downturns.

Caruso: The use of PIK toggle, covenant-lite or similar provisions may delay the ultimate time of reckoning – be that restructuring or the actual filing of a bankruptcy proceeding. However, it may not impact the onset of discussions of incipient financial problems. I believe there is a high probability that discussions for many companies will commence and some bankruptcies will be avoided by early discussions. We may see the results of these discussions expressed in things like exchange offers and pre-packs. A major assumption is that trade creditors, given first/second lien structures, will remain complacent and won't react precipitously.

Schnelling: Of course PIK toggle and covenant-lite loans delay the onset of a bankruptcy wave. However, one could argue that the use of such instruments will ensure that when it comes the wave will be deeper and the trough between the bottom of the wave and the beginning of the uptick much longer than if these instruments hadn't been so widely used.

Butler: I believe any delay in restructurings on account of PIK toggle and covenant-lite loans won't extend beyond the first restructuring amendment. While the PIK toggle feature of some debt instruments issued in the recent M&A cycle will allow some companies to switch back and forth from paying interest in cash to accruing interest expense on the balance sheet to be paid later, this provision will be among the first to be deleted in any amendment the company needs to obtain for other purposes. Similarly, covenant-lite deals will become populated with new and more restrictive covenants. The bottom line in the restructuring environment is that lenders will require such give-backs because they are focused on the trading value of the debt instruments and on maximising return on invested capital. In today's market, PIK toggle and covenant-lite have been replaced by original issue discount features whereby companies often receive 92 cents or less in cash on the 'borrowed' dollar.

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JEFFREY W. LINSTROM

Sprayregen: How have amendments to the bankruptcy code under BAPCPA – such as key employee retention plans (KERPs) and reclamation rights – affected a debtor's ability to restructure in Chapter 11?

Caruso: Many amendments under BAPCPA were proposed to eliminate perceived abuses of the process. Some clearly give an advantage to certain creditor groups. More importantly, the kinds of amendments enacted are somewhat asymmetric in their impact. This asymmetry occurs because special interests lobby or propose amendments to the code that are better for them. Prospective debtors don't seek amendments. The KERPs issue has the potential of impacting any reorganisation by making it more difficult to retain management talent – typically a very scarce resource. Amendments impacting lease and reclamation issues will certainly impact retailers, for example, by putting some restrictions on the timing of exiting/rejecting leases and satisfying reclamation claims. The safe harbour provisions and the ability to avoid the stay of contractual rights certainly impact the probability of reorganising financial services companies. There have not been enough cases yet to provide real evidence subsequent to the 2005 changes but directionally I believe that restructurings have become more difficult.

Kinel: By giving additional leverage to lenders and landlords, the BAPCPA amendments have made it more costly and challenging for businesses to reorganise and more difficult for existing management to control their company's destiny. BAPCPA imposed strict deadlines on some of the most important tools previously available to debtors, such as those relating to exclusivity and the assumption or rejection of leases. The amendments also significantly curtailed the use of KERPs by limiting companies' rights to make retention payments to key executives unless they can demonstrate that they are properly incentive-based and that they are fair and reasonable when compared to the treatment of rank and file employees. With respect to the expanded reclamation protections for sellers by way of an expanded reach-back period, debtors need to be prepared to fund what are potentially very significant additional administrative expenses, which may be payable at the

very outset of their cases, making cash starved debtors even less likely to successfully emerge intact.

Glass: Key employee retention plans continue to be controversial and local practice seems to affect what the courts and players will accept. We have not seen significant problems with employee retention.

Hammer: Although the amendments to the bankruptcy code under BAPCPA have made it harder on a debtor to file and restructure its debt in a Chapter 11 case, they have not made it impossible. Professionals involved in in-court restructurings, have become more creative with their strategies for achieving pre-BAPCPA results under the new amendments. For example, to obtain court approval of post-BAPCPA KERPs, despite the limitations imposed by BAPCPA under section 503(c), attorneys have tied incentives to the employee's ability to meet objective performance criteria or have obtained court approval of KERPs under section 365 of the bankruptcy code. Restructuring professionals, however, continue to struggle with the 20-day pre-filing administrative claim granted to vendors.

Schnelling: The objective of BAPCPA was to clearly shorten the time firms stay in bankruptcy by truncating the time allotted to accomplish certain critical bankruptcy related tasks – rejection or assumption of real property leases, proposal and confirmation of a plan, elimination of windfalls for managers encouraged to stay on and loot the company in bankruptcy, etc. Unfortunately, these changes have not translated into cheaper cases and many cases like United Airlines, which require longer periods than currently mandated under BAPCPA to emerge, will have great problems reorganising when oil prices drive them back to the Chapter 11 protection of the courts again. Mandating time frames when you can't know the specifics of the cases which will appear is a significantly worse way to handle insolvency than the traditional way of allowing constituents and judges to tailor the time of the case to the needs of the case.

Butler: The BAPCPA amendments to the bankruptcy code were particularly damaging to the viability of Chapter 11 as an effective restructuring tool. Most importantly, the amendments materially reduced liquidity in judicial restructurings by preferring suppliers that provide goods immediately prior to a Chapter 11 case filing and requiring that debtors make accelerated, and often non-value maximising, decisions about assuming leases and filing reorganisation plans. The limits on executive compensation programs in Chapter 11 are also troublesome. These limitations are not well articulated or designed but do reflect both the political strength of union organisations and poor corporate governance and compensation decisions made in isolated situations in the past. However, the notion that managers in a judicial restructuring should not be paid market wages and market incentives for turning around troubled companies is nonsense and ultimately destructive to reorganisation prospects and enterprise value. The fact that there continues to be stakeholder and judicial scrutiny of these programs is part of the healthy checks and balances in Chapter 11 reorganisations.

Key employee retention plans continue to be controversial and local practice seems to affect what the courts and players will accept.

RONALD GLASS

Linstrom: The reclamation change as well as the fixed time to assume or reject leases has made restructuring in Chapter 11 very difficult for retailers. Under the amended code, bankruptcy courts can now only grant debtors 210 days into a case to assume or reject leases. Before this amendment, bankruptcy courts would often grant debtors unlimited extensions of time to assume or reject leases while they worked out a reorganisation plan. This huge change means more and more retailers who enter Chapter 11 without a pre-negotiated deal will end up liquidating.

Sprayregen: How has BAPCPA's Chapter 15 impacted jurisdictional choice and recognition of foreign processes in cross-border insolvencies?

Hammer: BAPCPA's Chapter 15 sought to coordinate cross-border insolvencies by, among other things, streamlining the recognition process of foreign proceedings. While the increase in cross-border insolvencies may indicate that Chapter 15 has been successful thus far, case law interpreting Chapter 15 now suggests that recognition as a foreign proceeding is not a foregone conclusion. Indeed, recent decisions in SPhinX and Bear Stearns evidence US bankruptcy courts' hesitancy to recognise a foreign proceeding based solely upon the location of an entity's registered office. Bear Stearns and another recent case, Basis Yield Alpha Fund, illustrate that US courts will address this issue in the absence of objections from parties-in-interest and require the foreign representative to present evidence beyond the registration locale in order to obtain recognition of such proceeding as either 'foreign main' or 'foreign non-main'. These decisions now leave offshore hedge funds and their provisional liquidators scratching their heads in search of access to US bankruptcy courts without having to commence a full-blown Chapter 11 or 7 proceeding.

Kinel: Chapter 15 essentially now guarantees access to US bankruptcy courts provided that certain objective criteria are met. This represents a significant departure from its predecessor section 304, pursuant to which access to US courts by a foreign representative was discretionary. By establishing a simple, objective eligibility requirement, Chapter 15 promotes predictability and reliability. The considerations for post recognition relief remain flexible and pragmatic in order to foster comity and cooperation. Recent decisions such as the Bear Stearns case have made clear, however, that access under Chapter 15 has limits, and bankruptcy courts will not grant recognition or use their powers to effectuate the purposes of a foreign proceeding – even where there is no opposition to doing so – unless a debtor can demonstrate that it has its centre of main interests or at least an establishment in the country of the foreign proceedings.

Butler: It's probably to early to realistically assess the impact of Chapter 15 on jurisdictional choices. While it should be possible to file a Chapter 15 in the US, as opposed to Chapter 11 or Chapter 7, in certain circumstances, I don't think it will prevent cross-border companies from filing Chapter 11 reorganisation cases in the US if that is the right strategic option. Chapter 15 does provide a more assured path for recognising foreign processes but it's still very much an open question of whether and when to commence Chapter 15 cases – as a companion case, following completion of the principal foreign proceeding or at another logical point in time.

Caruso: The overarching objectives of Chapter 15 are enhanced cooperation among domestic and foreign courts, more certainty that facilitates trade and investment and enhanced probability of success in cross-border cases. All noble causes, but it is one thing to articulate the process on paper and another to make it work well in practice.

Linstrom: We live in a world where debtors are based in many countries. It was time for our bankruptcy code to catch up with this reality. I think the change has helped.

Sprayregen: To what extent are labour negotiations and pension shortfalls adding complexities to the restructuring process?

Caruso: Historically, contract negotiations, pension benefits and OPEBs have been substantial obstacles to reorganisations. Collective bargaining agreements, escalated from base levels established when the labour forces were much larger and the ratio of active/inactive workers more favourable, have been very difficult historically to modify in terms of wage rate, benefits, work rules, outsourcing, etc. Pension benefits, specifically shortfalls from defined benefit plans, and the role of the Pension Benefit Guarantee Corporation (PBGC) have been another complication. The good news is, at least we are getting better at resolving these kinds of issues as some precedents are established. We have also become more creative, as with the use of VEBAs, and labour has even embraced private equity/distressed investors such as in the Dana case.

Kinel: Labour and pension concerns have recently been brought into sharp focus in the context of airline and automotive industry cases. In each of these cases, the opportunity to shed unaffordable pension and healthcare costs was a crucial factor in the decision to enter Chapter 11, and in most the debtors made effective strategic use of the bankruptcy process to cut such costs. Debtors have often achieved these goals by eliminating jobs, decreasing wages and benefits, terminating or freezing pension plans and reducing or eliminating retiree health benefits – notwithstanding the protections afforded by certain sections of the bankruptcy code, which were enacted as instruments of restraint against such activities. Although labour issues and pension shortfalls certainly add complexities to the restructuring process – as seen, for example, in the ongoing pension battles in the Delphi Corporation case – for the most part bankruptcy has proven a winning strategy for companies seeking relief from labour and pension costs, and it is likely that companies will continue to file for bankruptcy protection in an effort to reduce such obligations. Nevertheless, these issues can often significantly delay or derail such cases, or even force an asset sale exit strategy rather than a stand alone reorganisation.

Labour negotiations will continue to inject serious complexities into restructuring processes...ignoring labour is perhaps the surest way to failure in corporate restructuring processes.

AARON L. HAMMER

Hammer: Labour negotiations will continue to inject serious complexities into restructuring processes. Approaching its four year anniversary as a Chapter 11 debtor, Interstate Bakeries Corporation (IBC) presents a prime contemporary illustration of the difficulties that labour negotiations raise in modern corporate restructurings. With over 295 separate collective bargaining agreements, IBC's restructuring has ground to a halt as the Teamsters and other labour unions exercise an effective veto on the debtor's exit from Chapter 11. Despite the power of the court to alter or nullify collective bargaining agreements, a restructuring process cannot address the most basic situation where essential labour chooses not to work. In short, ignoring labour is perhaps the surest way to failure in corporate restructuring processes.

Butler: Human capital is central to any successful restructuring. While the restructuring journey can be more complex when unions are involved, many of their leaders are also keenly focused on preserving jobs and enterprise value and recognise the importance of being constructive in complex restructurings. Similarly, the Pension Benefit Guarantee Corporation (PBGC) has developed a well deserved reputation of approaching complex business issues in a business like rather than bureaucratic manner.

Schnelling: Labour negotiations and pension shortfalls are not adding to restructuring complexities any more than they ever did. These are intractable problems at best and when they appear, in no way add to the ease of restructuring and speed of dealing with a case.

Sprayregen: In light of the significant introduction of second lien debt to capital structures in recent years, what added pressures do intercreditor arrangements bring to the table?

Schnelling: Covenant-lite second lien deals will materially add complexity to cases as the holders will fall somewhere between secured and unsecured creditors if they do not clearly – by the terms of the instruments – fall into one class or the other. Uncertainty adds complexity and second lien deals are fraught with complexity for creditors and debtors when they go wrong.

Glass: The balance sheets of today are certainly more complex than those of 10 or 15 years ago. There are many layers to the capital stack that just did not exist in the past. These complex balance sheet arrangements add an entire new flavour to complexities of a

bankruptcy or restructuring. The value fight is reached earlier in a case and can be more contentious. Often intercreditor agreements initially inhibit senior lenders, however ultimately they act in their own best interest.

Linstrom: Valuation fights will be more prevalent than in past downturns. We are seeing many more cases that would have been reorganisations in past years turn into liquidations through section 363 sales across all industries. The reason for this is that the first and second liens cannot reach an agreement and it is difficult to prove that the proposed restructuring will give the second liens as much as they would get in a liquidation.

Butler: The main and often dispositive difference in Chapter 11 cases where traditional unsecured bond indenture debt has been replaced by notionally secured second lien debt is that debtors enter Chapter 11 with few, if any, unsecured assets available to pledge for DIP financing or to sell to raise cash. As a result, many second lien dominated Chapter 11 cases are liquidity constrained. This often leads to the prompt abandonment of reorganisation within Chapter 11 to quasi-forced sales or asset liquidations that are usually quite prejudicial to unsecured creditors and more junior creditors including equity holders. That is not to say that debtors are without any tools at all to deal with recalcitrant creditors but it is more complex and uncertain than in the past, which adds to the costs of Chapter 11 and sometimes reduces reorganisation business enterprise value.

Caruso: The introduction of second lien debt has added a new dimension to the process. First, it may have removed any option of an outside DIP financing. Should the company need to file, there will be limited assets to collateralise a DIP loan and a 'priming' fight may be problematic. Second, trade creditors may become active given the lien structures and intercreditor agreements. Third, if the first and second liens have claimed all the value and these claims are memorialised in appropriate security filings and intercreditor agreements, the need for the existing bankruptcy process and the role of the courts becomes a question.

Hammer: An intervening bankruptcy may disrupt intercreditor agreements between secured creditors, causing outside pressure on restructuring proceedings and additional restructuring expenses. Notably, bankruptcy courts tend to uphold the essence of intercreditor agreements – the subordination of the second lien's right to payment only after payment-in-full to the first lien. However, ambiguity still exists as to whether courts will enforce ancillary terms in intercreditor agreements, such as a second lien's waiver of its voting rights on the debtor's plan. The second lien may also look to raise objections in the borrower's bankruptcy case, for example, with respect to DIP financing being provided by the first lien, despite the second lien's waiver of such rights in the applicable intercreditor agreement. In the end, if first lien lenders seek smoother and more efficient restructuring processes, they should pave the way to a successful restructuring by making reasonable concessions to the second lien lenders.

Kinel: Intercreditor arrangements complicate matters. For example, intercreditor agreements may contain waivers or consents by junior lenders for issues such as DIP financing, use of cash collateral, rights to adequate protection, section 363 sales of debtors' assets and senior lenders' rights to vote junior lenders' claims. An intercreditor agreement might also contain a provision permitting, or barring, a senior lender's issuance of additional debt to the borrower. Since the enactment of BAPCPA, and particularly in today's credit environment, time is of the essence in Chapter 11 cases. Where there is a highly restrictive and complex intercreditor agreement, junior creditors will likely contest the terms of the agreement. Such action saps critical time and resources, and can force senior creditors, particularly those with a small or no equity cushion, to offer junior creditors a recovery to resolve the case consensually and avoid, among other things, costly battles over valuation.

Sprayregen: Do you expect to see more out of court restructurings or court directed processes going forward? What factors – such as the composition of creditors – define which option is appropriate for a struggling company?

Linstrom: Debt will continue to change hands in and out of court as well as in court restructuring deals. We will see distressed debt players play an increasingly important role, as was the case in the Lampert and K-Mart transaction. Expect more of these cases where distressed debt buyers will control the outcome.

Kinel: Going forward, I think we will see more of both out of court restructurings and court directed processes. Given the difficulty of obtaining credit in the current environment, however, companies in bankruptcy can expect tougher terms and smaller loans from DIP and exit lenders. Together with the shorter exclusivity and lease rejection periods mandated under the BAPCPA amendments and high administrative costs, Chapter 11 cases may not solve the problems of certain struggling companies, such as retailers, if their goal is actually to reorganise. This is why we have recently seen a significant number of Chapter 11 cases quickly winding up as liquidations. It has become clear that most Chapter 11 cases will need to move on an expedited basis, resulting in the increased use of pre-negotiated, pre-packaged or at least highly pre-planned cases. Companies that free fall into bankruptcy are going to have an enormously difficult time emerging successfully.

Glass: The bankruptcy process has become extremely expensive. The shear cost of a bankruptcy is going to affect decision making in the distressed scenario. In some cases one party or another may feel like their situation might be better served by a Chapter 11 but understanding the cost and risk may cause them to take a different route for example an out of court work out to avoid the cost and risk of a Chapter 11. Creditors that are offered a compromise out

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of court may feel that they can get more in a Chapter 11 are starting to understand that the cost of the filing and process may erode any benefit they would get. We believe there will be an increase in out of court liquidations and sales of struggling companies as opposed to reorganisation. Creditors that have a shared vision of value and a shared perception of management can get a lot done out of the courts.

Schnelling: As the financial aspect of the economy continues to decline we should see increasing numbers of work outs for those firms whose equity group is well enough financed to inject capital, as debt or equity, to allow the debtor to restructure out of court or be sold. Other companies will face increasing pressure from lenders to turn over their keys or allow asset sales programs to take place. The greatest concern we have is the possibility that the economy could reach a point where there are few if any buyers for the companies that fail. The silver lining in that scenario is that non-productive assets will then be taken off line permanently for the first time in decades and allow healthier firms to thrive. The downside is the level of potential job losses for people who lack the ability to recycle their careers.

Butler: I believe that out of court restructurings have historically been the preferred path for companies except in circumstances where the companies are liquidity constrained or have particular strategic reasons to avail themselves of Chapter 11 reorganisation. Since the 2005 BAPCPA amendments have made that restructuring tool less desirable and stakeholders continue to press for faster, more certain and less costly restructuring alternatives, I would expect out of court restructurings to continue to be pursued as the preference with Chapter 11 cases filed when strategic or necessary.

Caruso: I would like to see more out of court restructurings. Out of court restructurings have a number of advantages including lower expense, speed and lack of the public disclosure of financial information. Court processes, however, have the advantage of the binding nature, continuing business/trade credit and limitation of claim amounts. In weighing the alternatives, it is a classic cost/benefit analysis.

Hammer: The current US trend towards court directed processes should continue over the near term. One notable exception is large retailers, which basically are required under BAPCPA to make assumption or rejection decisions on their commercial leases within the first 270 days of filing for court protection. Retailers that have filed for chapter protection have therefore opted for a quick sale as opposed to reorganisation, such as in the cases of Shaper Image and Bombay Co. Homebuilders may also invest substantial effort in out of court solutions due to limits of in court processes in resolving mechanics' lien and similar issues. However, whereas senior lenders may be willing to grant their borrowers multiple rounds of forbearance, the parties' inherently limited options in these situations often compels a formal proceeding, if only to provide greater structure for a negotiated resolution as in the recent Kimball Hill Chapter 11 case.

Sprayregen: What role are private equity, hedge funds and sovereign wealth funds expected to play as insolvency rates increase? Will they act as sources of capital to fund restructuring plans, and if so, what are the long term consequences for debtors?

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>
> ANTHONY H.N. SCHNELLING

Glass: We have already seen SWFs step into the financial sector in a big way. I suspect this trend will continue. There is a lot of foreign capital that believes that the US domestic market is a great long term play and offers a stable safe harbour for capital. In terms of domestic private equity firms there are a number that are very focused on distressed situations.

Caruso: I think private equity, hedge funds and SWFs will play an increasingly important role as insolvency rates increase. They represent a large pool of capital to fund plans. Specifically, they may be the source of capital for 363 sales transactions, may fund plans of reorganisation requiring new money or may move into fulcrum security positions via market transactions. These groups will somewhat compete with the internal reorganisation plans and will offer quicker market driven tests of enterprise value. It is possible that conditions in the credit markets could deteriorate further and cause some hedge funds to operate at lower leverage and thereby contract the supply of funds. SWFs have so much capital and their objectives may be more strategic than absolute return based. They may have 'political' issues. Private equity firms can raise vast amounts of money – the difference is that they cannot as readily leverage the transaction so asset prices may decline. My overall view is that these players increase the number of options to be considered and that, in general, is a favourable outcome.

Hammer: We should expect private equity, hedge funds and SWFs to play an increasingly vital role in the restructuring of US corporate enterprises. With the tightening of the credit markets, these investment vehicles will continue to exploit opportunities to replace traditional lenders and also participate in riskier credits that may pay larger dividends. These non-traditional investment companies also have the requisite capital and experience to participate in large scale corporate reorganisations. Corporate restructuring candidates can expect to answer to a new breed of activist and demanding fund participants, which will also likely seek to directly influence the corporate enterprise through participation on the company's board of directors.

This article first appeared in Financier Worldwide's *July Issue 2008*.
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Schnelling: Clearly any players who have dry powder and capital to employ will be sought after as angels for firms in restructuring or bankruptcy as insolvency rates increase. Given the level of sophistication of these players any market that also has included a shake-out among such firms will be more selective about what they invest in.

Butler: Except for the rise of sovereign wealth funds, I don't think that there is any headline news regarding the involvement and dominance of investment players in restructuring situations. Perhaps the biggest wrinkle in the involvement of private equity, hedge funds and SWFs is the fact that they are constantly marking virtually every investment situation to the actual or perceived market trading price. As a result, restructuring negotiations have become much more complex as short term market pricing has penetrated the negotiating table. Furthermore, market players often move in and out of debt and equity positions making it difficult to sustain a restructuring plan from negotiation through implementation. Another problem is that the intrinsic value of an enterprise is often being supplanted by short term trading value when sorting out business enterprise valuation. This is a very troubling trend because it tends to capture any upside in a business for more senior parts of a capital structure to the detriment of junior creditors and equity holders.

Kinel: Hedge funds, which have already made a huge impact on the dynamics of the bankruptcy process, will continue to participate actively in bankruptcy cases, including holding secured and unsecured debt, providing DIP and exit-financing loans, purchasing or trading debt for equity and sponsoring plans of reorganisation. Hedge funds have been aggressively providing 'loan to own' financing. Some private equity firms, on the other hand, are taking a beating on certain acquisitions made in recent years, in many instances seeing their entire investment wiped out. Private equity firms will be taking a closer look at the companies in which they invest, including performing more due diligence.

Linstrom: Hedge funds will become increasingly more active, and we are likely to see many more 'loan to own' deals transacted. However, the role that private equity funds play will largely depend on how easy or difficult the credit markets will make it for them to obtain debt. The large appetite to buy companies out of Chapter 11 that we have seen in the past five years was largely driven by the availability of favourable debt financing. Clearly, we have seen a fundamental shift back to what I view as more traditional credit availability, and as a consequence, there are no longer going concern buyers for every debtor.

Sprayregen: Looking ahead, what prevailing trends do you expect to see in restructuring solutions and bankruptcy processes?

Butler: I expect to see more restructuring activity over the next 18 months and continuing through the end of the decade with an emphasis on out of court situations. There will continue to be Chapter 11 cases at all cap tiers and in diverse business sectors, however, I expect to see more Section 363 sales, liquidations and pre-negotiated reorganisations as opposed to traditional Chapter 11 cases. Senior creditors and special interest groups have much more leverage going forward than in the past but they will need to moderate their use of leverage or will likely face protracted litigation from unsecured creditors and equity holders that will have nothing to lose.

Hammer: In addition to a continued focus on out of court restructurings, we should continue to see an increase in pre-packaged Chapter 11 restructuring plans for at least the remainder of 2008. In January and February alone, we saw four pre-packaged Chapter 11 cases filed for publicly traded companies – one short of the entire 2007 total. Notable BAPCPA changes, such as the 270-day limit on the debtor's ability to assume or reject its commercial leases, the expansive 20-day administrative claim rights for vendors and the limitations on the debtor's plan exclusivity period, undoubtedly have encouraged debtors to consider pre-packaged plans, as well as to continue focusing on out of court solutions.

Schnelling: Right now we see no clear direction on solutions although with the presence of BAPCPA in the mix section 363 sales and sponsored plans are likely to play a significant part in this arena. Beyond that we expect to see a lot of one off solutions reflecting case specific facts and few clear trends.

Glass: Due to the cost, risk and time a bankruptcy will consume, we believe that the push for out of court workouts will increase. Another area that we see an increase in demand is in the role of the fiduciary, or responsible party. In such situations the players around the table are not going to cede control to each other, but will also feel the need to make a change. We have also seen an increase in bankruptcy litigation or litigation leading up to the restructuring process. Litigation is becoming an important tool in the work out area.

Linstrom: The biggest trend we see in the next wave is over leverage and intercreditor battles making it more difficult to consummate successful restructurings.

Kinel: While the only predictable thing about bankruptcy related predictions is that they are usually wrong, it seems inevitable at this point that there will be many more distressed businesses that will need to be restructured either in or out of bankruptcy, and many will not successfully make it through the process. The recent effective collapse of the Macklowe real estate empire, although resolved without resort to litigation, raised serious questions about the over-leveraging of significant real estate assets and the rights between numerous mezzanine and other lenders, which may be repeated in other contexts. I also expect to see an increase in litigation as a tool to extract value for certain classes of creditors as asset values continue to shrink and we find more players sitting at the bankruptcy table whose interests are hopelessly opposed to one another as a result of increasingly complex capital structures.

Caruso: Simplistically, the old test was reorganisation versus liquidation value and the new test is reorganisation versus sales value. Some legal academics have characterised this as creditor-in-possession as opposed to DIP. We still have a functioning bankruptcy process, perhaps slightly worn, and the rules will continue to evolve. As professionals we will need to adapt to the changing paradigm. ■

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