

# U S B A N K R U P T C Y R O U N D T A B L E



## US BANKRUPTCY

Many companies in a liquidity crisis have been unable to refinance their debts or meet working capital needs. Troubled firms have struggled to raise financing for turnaround initiatives. Traditional restructurings under the Chapter 11 process have been difficult, with section 363 sales and liquidations more prevalent over the last two years.

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**Sprayregen:** How would you describe the US bankruptcy market over the last 12-18 months? In your opinion, what are the reasons behind lower than anticipated Chapter 11 filing activity in the US during 2010?

**Carson:** In 2009, Chapter 11 filings reached record levels primarily due to challenged credit markets, decreased consumer spending, increased unemployment and a decline in consumer confidence. Conversely, in the first half of 2010, improved credit markets along with the ‘amend and extend’ phenomenon have contributed to the decrease in the number of Chapter 11 filings. According to a recent report from Bank of America Merrill Lynch, 60 percent of proceeds from US high-yield bond issuance were used to refinance existing debt alleviating liquidity pressures. Corporate restructuring and turnaround professionals warn that these refinancings have not ‘fixed’ companies’ operational problems; rather, they have simply ‘kicked the can down the road.’ As a result, the US corporate-default rate is predicted to drop to 4 to 5 percent by the end of 2010, versus 13.7 percent in 2009.

**Strochak:** In 2008 and 2009, the US market saw a wave of mega-cap Chapter 11 cases triggered by the worldwide financial crisis and the evaporation of credit, as well as industry-specific filings caused by intense distress and structural changes in specific sectors such as automobile manufacturing and print media. With every ‘generation’ of Chapter 11 work, the size and complexity of the largest cases continues to grow. As if there were a Moore’s Law for bankruptcy cases, Lehman Brothers exceeds Enron and WorldCom in scope and difficulty, just as those cases surpassed their predecessors. The modest reduction in filings for 2010 is the result of freer credit, willingness of mortgage lenders to amend and extend secured debt in the real estate industry, and aggressive inventory and expense management in industries like retail, allowing businesses to sustain their cash flow despite lower sales volumes.

**Golubow:** The past 12-18 months have been extremely busy for restructuring professionals with many working around the clock. Yet, this period has seen more normalised levels of business bankruptcy activity in relative comparison to the height of the financial crisis that unfolded approximately two years ago brought on by the bankruptcies of Lehman Brothers, Washington Mutual Inc., and General Motors Corp. Chapter 11 business bankruptcy filings nationwide fell approximately 17 percent in the first six months of 2010 in comparison to the same period in 2009, according to the American Bankruptcy Institute. The drop in Chapter 11 corporate bankruptcies is a result of historically low interest rates, and a booming high-yield debt market, which have allowed companies to refinance or amend and extend loan maturities. Filing activity alone is misleading since a drop in bankruptcy filings does not measure the increase in out-of-court restructurings for many busi-

nesses including those involving complex commercial mortgage-backed securities.

**Wolf:** Until the first calendar quarter of this year, the market was quite robust. It has ebbed somewhat during the past six to nine months. I would have to speculate regarding the reasons behind the lower than anticipated Chapter 11 filings this year. I frankly do not believe the reasons are rooted in the purported economic recovery. From my perspective, the recovery has been, at best, spotty and uncertain. The decreased amount of Chapter 11 activity is probably due to a combination of factors including greater reliance upon out-of-court restructurings and the fact that many businesses that were ‘on the bubble’ at the time the recession first hit have already gone through the reorganisation or liquidation process.

**Derrough:** Clearly the market has slowed in terms of the volume and intensity of restructurings and Chapter 11s. In January 2009, there were huge fears about where the world was going and whether the financial system would completely collapse. Today, the system is much more stable. Companies that still need to restructure have been afforded more time to do so. The resurgence in the credit markets has allowed many companies to refinance any upcoming problems. So it remains fairly quiet out there. There are still restructurings, but certainly the activity has declined – except for the real estate market which continues to pick up.

**Chatz:** The business bankruptcy market over the last 12-18 months has been tepid at best. This can be attributed to a number of factors such as the erosion in values of business enterprises in recent years, the unavailability of financing, and, somewhat related to financing issues, the unwillingness of parties involved to fund a Chapter 11 proceeding which is an expensive process. Often liquidation scenarios outside of Chapter 11 are more cost effective and as such the utility of Chapter 11 has and likely will continue to wane.

**Hammer:** The US bankruptcy market over the last 12-18 months has been markedly different from past recessionary periods due, in large part, to the capital markets, which remain generally closed to refinancing corporate debt or debtor-in-possession financing. Given this reality, lenders have been more willing to forbear from exercising default remedies against their borrowers (commonly known as ‘extend and pretend’), or alternatively, sought to avoid the high cost of Chapter 11 by liquidating severely distressed credits by state law assignment proceedings or receiverships. The result has been lower than anticipated Chapter 11 filing activity for a recession of this magnitude, particularly over the past nine months.

**Ziman:** The US bankruptcy market has been, in a word, ‘slow’ over the past 12-18 months. There have been only a handful of middle-market filings and even fewer large-cap bankruptcies. The most readily apparent explanation is liquidity. The US bond market has, for the most part, been wide open since late May 2009 as capital has sought the (alleged) relative safety of fixed income over equities. This resurgence of liquidity has allowed companies, even those with considerable leverage and signs of distress, to utilise exchange offers and other out-of-court strategies and defer more comprehensive balance sheet restructurings for a later day.

**With every ‘generation’ of Chapter 11 work, the size and complexity of the largest cases continues to grow.**

ADAM STROCHAK

**Sprayregen:** In the current market, are you seeing more out-of court restructuring solutions, such as pre-packaged or pre- ▶▶

**negotiated bankruptcies, or are more companies being forced into liquidation scenarios?**

**Hammer:** Full-scale Chapter 11 reorganisations remain relatively low, due largely in part to tight credit markets and the paucity of refinancing or debtor-in-possession financing opportunities. Borrowers and lenders alike have increasingly turned to out-of-court restructuring and liquidation solutions, which offer many (but not all) of the benefits of Chapter 11 protection at significantly lower cost. Undoubtedly, in cases where lenders believe that their borrowers are beyond any hope of reorganising, they are taking advantage of non-bankruptcy liquidation options – such as UCC Article 9 sales, assignment proceedings and receiverships – that are faster and cheaper than Chapter 11. And where Chapter 11s are being filed, they are often being conducted on a pre-packaged or pre-negotiated basis, in an effort by debtors and their senior lenders to minimise costs.

**Chatz:** The pre-packaged or pre-negotiated bankruptcy solutions are generally limited to entities which are the subject of multiple layers of indebtedness where the parties are willing to cooperate with one another to maintain the ongoing business enterprise for the benefit of the aggrieved parties. This is a very limited universe. The current market reflects that either lenders are willing to continue to support their customers or out of court liquidations are the preferable solution when collateral values are decreasing or the business model was false or is no longer workable.

**Derrough:** We're seeing more out of court restructurings and pre-packs than we saw 18 months to two years ago. A reasonably high percentage of those combine new money as well as exchanges of debt. Contrast this to the situation 18 months ago when companies were literally running out of money. The only way to finance them and avoid shutting the business down, was to use the DIP financing process. In other cases, some transactions were effectively preying on the fears of credit investors in what may be described as opportunistic or even coercive balance sheet restructurings, done on an out of court basis. Companies were swapping unsecured debt for secured debt at a discount, or they were tendering at a non pro rata, non par basis for bank debt. Lack of market liquidity allowed companies to use those tools to deleverage their balance sheet without having to enter a bankruptcy process. Today's out of court deals are a little different as opportunistic deals are not available any more.

**Ziman:** Consistent with what we saw during the darkest days of the financial crisis, the vast majority of filings continue to be either pre-packaged or pre-negotiated. There remains a perception in the eyes of corporate boards and management that a company without a deal on the way into Chapter 11 may never come out. In some respects the debtor in possession financing market reinforces this thinking, as such loans remain difficult to obtain without having a fully-baked exit strategy. Ironically, this has led companies to reach for a pre-bankruptcy deal, even in situations where there is a possibility (or likelihood) that the creditor-counterparties are not holders of the actual fulcrum security.

**Strochak:** There has not been dramatic change in the procedural mechanisms used to restructure troubled companies. The current wave of restructuring work takes all forms. As in any down-cycle, there are some companies that can restructure their debts out of court and others that require the tools of Chapter 11 to accomplish the task. Pre-packaged and pre-negotiated Chapter 11 cases

**Traditional Chapter 11 reorganisations have largely been supplanted by faster and more cost-efficient strategies.**

RICHARD H. GOLUBOW

continue to be attractive because they typically are cheaper and quicker than traditional 'free-fall' Chapter 11 cases and minimise business disruption. Changes to the US bankruptcy code in 2005 brought predictions of more liquidations, and this has been borne out in retail bankruptcies where the code now makes it harder to restructure companies with large portfolios of leases, but overall there hasn't been a big increase in liquidations in large- and mid-cap cases.

**Wolf:** In recent months, there have been a number of pre-negotiated bankruptcies involving true debt restructurings – where payment terms are altered, paper is exchanged, etc. By and large, however, Chapter 11 is now used as a procedural mechanism to effectuate a liquidation sale of the assets of the debtor to a 'financial' or 'strategic' purchaser – often for the sole benefit of the secured creditors and, in some cases, insiders of the debtor. Ironically, the use of Chapter 11 as a device to conduct a liquidation sale for the primary benefit of the secured lender was almost unheard of 30-40 years ago and is, in the view of many old-guard bankruptcy 'purists', a wrongful and horrific use of Chapter 11. Nonetheless, this practice has proliferated exponentially in recent years.

**Carson:** The slight decrease in the number of pre-packaged or pre-arranged bankruptcies that we've seen thus far in 2010 indicates that both debtors and creditors are more willing to negotiate alternatives to a traditional Chapter 11 filing. Yet, while the lack of liquidity in the market 12-18 months ago drove more companies into liquidation, lenders today are more willing to negotiate and work with borrowers if the lenders deem their recovery prospects to be more promising under an accelerated Chapter 11 process. Because of this dynamic and the uncertainty of the financial markets, we may see the trend continue towards accelerated bankruptcies, both pre-packaged and pre-negotiated solutions, as a means for lenders and debtors to maximise recoveries.

**Golubow:** Traditional Chapter 11 reorganisations have largely been supplanted by faster and more cost-efficient strategies such as pre-packaged or pre-negotiated plans of reorganisation or expedited sales of substantially all assets of a debtor's business. This trend has been driven by the realisation that traditional Chapter 11 reorganisations have proven to be costly and disruptive for corporate debtors, and because debtor-in-possession financing, the monetary lifeblood necessary to sustain a debtor through the bankruptcy process, has all but dried up since the latter part of 2008. Recently, the only entities typically able or willing to supply debtor-in-possession financing are the debtor's captive pre-petition lenders. ▶▶

**Sprayregen: In which sectors do you expect to see increased Chapter 11 activity over the next 12-18 months?**

**Wolf:** I expect to find continued, if not increased, Chapter 11 activity in the real estate, media, construction, financial services including insurance, and advertising areas. I would not be surprised, for instance, to find that there is an upward trend in receiverships and bankruptcies involving banks, bank holding companies, insurance companies, and insurance holding companies.

**Ziman:** I would expect to see the most activity in two areas: discretionary consumer goods/retail and the '2007 vintage' LBOs. US consumer spending remains moribund as unemployment continues to hover near 10 percent and depressed home prices have eliminated the home-equity 'ATM' machine. Even consumers with free cash are saving at rates not seen in the US for quite some time. Consequently, discretionary consumer goods manufacturers and retailers of those same products will face continuing top-line pressure. This creates continuing uncertainty around whether those businesses will be able to lower costs to maintain margin and generate sufficient earnings to meet their obligations. There also remains substantial doubt around whether many of the companies taken private at the height of the debt bubble can address 2012 and 2013 maturities.

**Strochak:** Print media will continue to see restructuring activity as that industry grapples simultaneously with disruptive technological changes and a challenging advertising sales environment. Retailers face significant challenges and a disappointing holiday season could prompt a wave of filings in early 2011. Commercial real estate continues to face mortgage maturities on office and retail properties that no longer command anywhere near the rents they previously attracted; this is particularly true for second- and third-tier properties. The gaming industry is likely to face continued distress due to reduced leisure travel and personal income, as well as increased competition from new gambling venues. We also may experience a wave of municipal bankruptcies as local governments struggle with reduced tax revenues.

**Derrough:** The real estate world continues to be a source of defaults and therefore restructurings. The peculiar aspects of real estate financing sometimes short circuit the restructuring process and basically force a quick, almost foreclosure-like process. Infrastructure projects are falling flat. Deals done in the 2004-07 period, which historically would have been financed by states or local municipalities, were backed by private parties with terms tied to the growth of the economy. But the expected economic growth failed to materialise. The power sector will probably see distress again, although how intense and deep that will be is any-

one's guess.

**Chatz:** If there is a reason for the utilisation of Chapter 11, one of the main areas of increased utilisation will be in the retail arena to facilitate lease rejection and restructuring, if demand for goods exists post the Christmas season. There may also be an increase in the public/government sector due to the poor economic condition of many states. Finally, it remains to be seen whether the health care reform will lead to changes in that sector with respect to Chapter 11.

**Hammer:** Suffocating from a dormant real estate market, development, construction and related companies will likely be at the forefront of Chapter 11 activity in the next 12-18 months. Recent statistics suggest that the commercial and residential real estate markets will remain in a depressed state for the foreseeable future, and accordingly, we anticipate that Chapter 11 filings of homebuilders, developers and commercial landlords will remain at high and perhaps even spike. We also anticipate that the banking sector will continue to suffer at the hands of this recession, and as a result, a substantial number of regional and local bank holding companies will eventually file for federal bankruptcy protection under Chapter 11. This prediction will be borne out by a significant increase in FDIC bank takeovers and related receiverships.

**Golubow:** I expect to see increased Chapter 11 activity in the commercial or non-residential real estate sector and the related construction sector, as well as in the manufacturing, retail and leisure and hospitality sectors.

**Carson:** I expect to see increased Chapter 11 activity in the real estate sector and related industries as a result of the high level of scheduled CMBS (commercial mortgage-backed securities) maturities over the next 12-24 months. But rather than focus on particular sectors to gauge future levels of distress, we should examine businesses that have debt maturities occurring as part of the projected 'wall of debt' between 2012 and 2014 – Standard & Poor's forecasts that in 2011, approximately \$120bn of speculative or junk-bond debt is scheduled to mature; by 2014, the total speculative-grade debt is expected to reach \$550bn. Depending on the state of the credit markets over the next few years, the 'wall of debt' creates a whole new universe of businesses that will face considerable credit issues and drive industries into distress.

**Sprayregen: What are some of the current issues and emerging trends that you have seen in relation to credit bidding? For example, how is credit bidding treated in a 363 sale in contrast to a reorganisation plan?**

**Golubow:** The ability of secured creditors to credit bid if the collateral securing their debt were sold in a bankruptcy proceeding is often viewed as a fundamental creditor right. A recent decision from the United States Court of Appeals for the Third Circuit, the appellate circuit for cases pending in Delaware, New Jersey and Pennsylvania, however, found that a secured creditor may not have a right to credit bid in the context of a plan of reorganisation that involves a sale of collateral. In the Third Circuit's decision in *In re: Philadelphia Newspapers LLC*, the court held that Bankruptcy Code Section 1129(b)(2)(A) is unambiguous and that a plain reading of such provision permits a debtor to sell the collateral securing a loan without allowing the secured lender the opportunity to credit bid its claim so long as the debtor's plan provides the secured lender with the 'indubitable equivalent' value of ►►

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KEN ZIMAN

its collateral. Generally, a secured creditor with a large undersecured claim has substantial leverage in a bankruptcy proceeding because it has the ability to credit bid its claim at auction and potentially chill the bidding process. Without the right to credit bid the full amount of its claim in the context of a plan imposed on the creditor through cramdown, a secured creditor with a large undersecured claim could be denied the opportunity to acquire the debtor's assets at a discount so long as the proposed plan otherwise affords the undersecured creditor the indubitable equivalent of its secured claim.

**Chatz:** Given certain court decisions that have occurred over the past number of months, the utility of section 363 without facilitating the use of the same through a plan of reorganisation, may not provide the comfort to asset purchasers that section 363 sales once provided. Chapter 11 plans are much more expensive than 363 sales and until the risk relating to certitude in sales is eliminated, pricing on distressed assets will be materially impacted. Out of court sales will increase with the parties understanding the potential of risks relating to section 363 and factoring the same into their purchase prices.

**Hammer:** The 2005 BAPCPA amendments, coupled with constricted credit markets, have combined to put secured creditors in the driver's seat in section 363 asset sales. Nowhere is this influence more prevalent than with a secured creditor's right to credit bid; indeed, we are seeing increasing interest by secured creditors in acquiring their borrowers' businesses out of Chapter 11 by credit bidding their debt. That said, however, the right to credit bid has come under recent attack. Almost two years ago, the 9th Circuit Bankruptcy Appellate Panel surprised the bankruptcy community in Clear Channel by holding that a lender's successful credit bid did not extinguish junior liens. Regardless of whether or not credit-bidding results in more robust auctions, the right to credit bid, previously viewed as sacrosanct, is no longer absolute in some jurisdictions.

**Ziman:** Credit bidding became increasingly popular in the last downturn, as the prospects for third-party sales were non-existent due to lack of financing and pervasive uncertainties about the nature and extent of the downturn. Opportunistic debt purchasers using secured loans bought at a discount as cheap currency fuelled this trend. Also, the courts generally facilitated credit bidding by rebuffing attempts by minority secured lenders to resist the will of the majority (for example, Metaldyne Industries). Most of the successful credit bids were employed in the context of 363 sales, with only a handful incorporated into Chapter 11 plans. I think that trend will continue.

**Strochak:** Recent appellate court decisions in the US have cast doubt on the ability of secured lenders to credit bid under a plan of reorganisation that provides for the sale of the lenders' collateral. Decisions of the Courts of Appeal for the Third and Fifth Circuits have concluded that a lender does not have an absolute right to credit bid when an asset is sold under a plan, although they do have a statutory right to credit bid at a sale conducted outside of a plan. These developments come at a time when credit bidding is increasing, particularly as a tool to enable hedge funds and other distressed debt investors to execute on 'loan-to-own' strategies where they buy secured debt at a discount in an eventual effort to acquire the assets securing the loan.

**Carson:** A long-held assumption among secured creditors was that they would be permitted to credit bid at a collateral sale,

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## Recent case law calls into question whether secured creditors can credit bid during an asset sale.

JONATHAN A. CARSON

whether under a §363 asset sale or as part of a Chapter 11 plan, to protect the recovery of their claim. Recent case law calls into question whether secured creditors can credit bid during an asset sale when a plan of reorganisation can provide them with the 'indubitable equivalent' of their claim. The impact of these recent case developments on the credit bidding process remains to be seen; however, it is possible that more sales will occur as part of the plan-confirmation process rather than under a §363 sale, which may provide debtors with more options when liquidating assets.

**Derrough:** There is always a question about whether credit bidding effectively chills an auction process. When you've got a big credit bid situation, are you able to generate a competitive dynamic that encourages people to bid up? In the end it all depends on the situation and the implied value against the secured debt. Is it 20c on the dollar or 70c on the dollar? How high will people go to win against the creditors in the credit bid?

**Wolf:** This past Spring, in the Philadelphia Newspapers case, the United States Court of Appeals for the Third Circuit – which issues controlling law for the District and Bankruptcy Courts of Delaware, among other states – proscribed credit bidding by lenders in connection with sales conducted pursuant to Chapter 11 plans of reorganisation, as distinguished from sales conducted under Section 363 of the Bankruptcy Code. Although the Philadelphia Newspapers case was originally decided by a three-judge panel of the Third Circuit, the Circuit later denied a rehearing by the entire Court. Hence, that ruling remains 'good law' in the Third Circuit. Needless to say, since the day it was published, the Philadelphia Newspapers decision has been under constant attack in the banking community and by attorneys that generally represent secured lenders. To my knowledge, no other Circuit has addressed the issue directly.

**Sprayregen:** Given the complexities of constituencies involved in a Chapter 11 restructuring, what insight can you provide into handling rights offering strategies and processes?

**Ziman:** Rights offerings have become more popular over the past several years as traditional sources of exit financing (that is, banks) became less readily available. They have also been used effectively by senior constituencies to validate Chapter 11 plan values and by junior participants to raise capital at higher than proffered plan values and payoff senior indebtedness. We have also seen rights offerings used 'offensively' by market participants in an effort to capture a disproportionate share of the equity of a reorganised debtor, often at a considerable discount to 'plan ►

value', by virtue of fees or discounted 'direct investment' components. In this regard, it is important to market test rights offering proposals to gauge whether any such discounts or fees are fair to those that are precluded from participating in a new capital raise.

**Strochak:** A rights offering, typically backstopped by a plan sponsor or investor, has become a common mechanism for financing a company's emergence from Chapter 11. A key consideration in any rights offering is the ability of the company to provide freely-tradable securities, and the easiest way to do that is through section 1145 of the US bankruptcy code, which permits the issuance of freely-tradable shares without necessity for the time-consuming and expensive registration process under the securities laws. To qualify for section 1145 treatment, the rights offering must be made 'principally' in exchange for claims against the company. A rights offering must therefore be structured in a way to ensure compliance with section 1145.

**Carson:** In the wake of the financial crisis, more companies undergoing Chapter 11 bankruptcy seek rights offerings to raise financing needed to successfully execute and emerge from Chapter 11. As part of this process, there are important steps that must be taken to ensure that public-securities holders are being contacted in an appropriate and timely manner, and that procedures are in place to conduct the rights offering within the parameters of the case. The involvement of public-securities holders in bankruptcy requires debtors and their professionals to enlist necessary support and expertise to navigate key case milestones – including plan solicitation, ballot tabulation and plan distributions. Taking a proactive approach to dealing with the administrative challenges of rights offerings in Chapter 11 cases can result in a smoother, more efficient outcome.

**Derrough:** One obvious class that should have access to the benefits of a rights offering, from an absolute priority basis, are those who are taking a hit but retain some value to their claims. A viable strategy for this class is to win the support of other constituents who may be more out of the money or tied to other parts of the capital structure by allocating a portion of the rights offering to them. Of course, the first group is probably the major impaired class and will likely object to giving up any value to people below them. So, ultimately, it becomes a negotiated settlement.

**Hammer:** With the current lack of traditional secured debtor-in-possession or exit financing available to distressed companies, rights offerings can provide a viable alternative source of funding for bankrupt companies looking to pay down existing secured debt or to provide liquidity necessary to successfully exit Chapter

11. In recent years, rights offerings also have increasingly come into favour as a mechanism for distressed investors to exert considerable influence over Chapter 11 reorganisations, and to obtain control positions in a corporate debtor post-bankruptcy. Given these realities, rights offerings will necessarily impact every major constituency in a Chapter 11 case – including existing secured lenders, unsecured creditors and existing equity holders – thereby underscoring the need for debtors to proactively involve and consult with such constituencies when contemplating or structuring Chapter 11 rights offerings. Building consensuses in rights offerings will reduce costs, expedite the process and minimise bankruptcy court challenges thereto.

**Chatz:** Realities of the marketplace drive parties' expectations in Chapter 11. Rights, offerings or otherwise – the parties must come to the determination as to what the underlying collateral is worth and what sacrifices they may wish or need to make in supporting their constituencies. Absent agreement, litigation over these circumstances erodes the value of the product/collateral and benefits professionals at the expense of the parties. Counsel needs to be in a position to bring their clients to the reality of circumstances, if possible, or the process leads to liquidation and lack of recovery.

**Golubow:** A rights offering is a source of equity capital via a Chapter 11 plan that is becoming more commonplace as a substitute for scarce traditional institutional financing. A right is similar to a warrant as it provides the holder with the right, but not the obligation, to purchase securities from the debtor company at a set price on or before an expiration date. A rights offering is a security of the debtor, offered via a confirmed Chapter 11 plan by complying with certain provisions of the Bankruptcy Code that allow for a debtor emerging from bankruptcy to offer new securities under the Securities Act of 1933 without the requirement of registration, which would add significant time and expense. Critical to a rights offering is to engage financial restructuring experts as the bulk of the legal analysis of rights offerings turns specifically on the valuation ascribed to the recovery on creditor claims. It is irrelevant whether the prior claims are for debt, preferred stock, or trade obligations. The new security simply has to be sold or exchanged principally in exchange for claims and partly for cash.

**Sprayregen:** What strategies are creditor committees using to enhance their recoveries given the high volume of 'short sales' by senior lenders in liquidating Chapter 11s?

**Chatz:** Successful committees determine collateral value and the availability of excess assets for the benefit of their constituents in short order. It is also important to assure that any sale process is properly conducted by the debtor and its representatives and lock up circumstances are avoided. There are very few sales occurring of any assets of any type or nature in the marketplace at the current time via auction sale. Creditors committees must be assured that sufficient marketing efforts have been undertaken and that time for potential purchasers is provided notwithstanding protestations of lenders or other constituents who wish to maximise value potentially on an expedited basis to close their books on a bad deal at the end of a quarter or fiscal year. In addition, committees must look to over reaching by lenders into the debtor's operations pre and post filing. However, inappropriate actions by lenders are rare and the expense of bringing causes of action, given lack of liquidity in most cases, is speculative at best.

**Wolf:** In most situations, creditors committees are relying upon ►►

## Rights offerings will necessarily impact every major constituency in a Chapter 11 case.

AARON L. HAMMER

very traditional strategies to extract and enhance unsecured creditors' recoveries in liquidating Chapter 11 cases. By and large, those strategies have not changed in the 36 years during which I have practiced bankruptcy law, although such sales have become far more commonplace in recent years. There are a number of committee strategies being adopted. First, the conduct of a comprehensive search for a chink in the armour of the senior secured lender arising from, among other possible actionable mistakes, a failure properly to perfect a lien, the acceptance of a preferential lien or constructively fraudulent transfer, or some other behaviour that could give rise to a lender liability claim. Second, the commencement, or threat of commencement, of litigation on account of such claim. Third, an intelligent attack on the sale process that is based upon, among other possible defects, some or all of the following circumstances: inadequate marketing effort, insufficient disclosure to would-be bidders, insufficient time for would-be bidders to conduct pre-auction due diligence, sale procedures and terms (including but not limited to 'break-up fees' and 'bid cushions') that chill the bidding process.

**Hammer:** Market conditions unfortunately have made the primary task of creditors' committees – maximising recoveries for unsecured creditors – increasingly difficult. With valuations at record lows, asset sale proceeds are generally insufficient to satisfy secured lenders' claims in full, let alone yield a surplus for unsecured creditors. Given this reality, creditors' committees have no choice but to employ creative – and sometimes aggressive – strategies to uncover value for their constituents. Committees and their professionals, faced with the prospect of complete disenfranchisement, often must immediately take the offensive, using their investigative powers to identify potential litigation claims against key parties, and carefully scrutinising proposed sales and bidding procedures to generate tactical advantage at the negotiating table. Quite often, a legitimate threat of litigation or other impediment to an expedited sale transaction – both of which can cause costly delays in a debtor's efforts to liquidate or reorganise – serves as the impetus for a settlement that yields valuable consideration to unsecured creditors.

**Golubow:** Many times the 'short sale' scenario occurs upon a debtor filing for bankruptcy after the debtor and its secured creditor have had extensive pre-petition negotiations – without any input from an ad-hoc or unofficial unsecured creditors committee – regarding a proposed quick sale of the debtor's assets. With little response time, committees will object to the debtor's first day motions whether a request for financing that provides overreaching protections to the pre-petition secured creditor, sale and bidding procedures or the outline of a Chapter 11 plan. This strategy is used by the committee to provide a forum whereby the debtor must include unsecured creditors in reorganisation negotiations, as opposed to further pursuit of the pre-petition tact to ignore or disenfranchise all but secured creditors. The goal is to slow down the case, gain leverage and provide value for unsecured creditors that otherwise are out of the money. The objections could delay the case long enough to give unsecured creditors more time to obtain substitute financing that may provide distributions, albeit over time, to unsecured creditors. The success of such tactics has prompted struggling companies and their lenders to take steps to fend off challenges such as by shopping the assets of a business pre-petition or including small carve-outs or cash 'gifts' for unsecured creditors in their Chapter 11 plans to generate support.

**Ziman:** Creditor committees, both official and ad hoc, continue

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WILLIAM Q. DERROUGH

to employ traditional strategies in an effort to obtain a recovery where unsecured creditors are otherwise 'out of the money' – investigation and litigation regarding lien perfection or other matters; valuation challenges, including efforts to extract distributable value from the typically unencumbered 35 percent of foreign subsidiary stock; seriatim objections to sale procedures, DIP financing and other relief necessary to effect the 'short sale'. If played correctly, these tactics may result in a carve-out of some modest value for unsecured creditors. More typically, however, unsecured creditors need to develop a viable, fully-financed alternative in order to avoid little to no recovery scenarios.

**Strochak:** The best strategy for unsecured creditors usually is to avoid liquidation in the first place, so often unsecured creditors will seek an alliance with management and make a debtor-in-possession loan to facilitate a possible reorganisation effort. Faced with a short sale, creditor committees will seek to delay the Chapter 11 process, to allow time for the company to formulate a business plan and attempt to reorganise. Committees also will seek to investigate and pursue avoidance actions or other claims against secured lenders, challenging their liens.

**Carson:** Creditor committees seek to enhance their recoveries in a variety of ways to balance the potential risks and losses that can be incurred within liquidating Chapter 11s in today's market. In some instances, they look to the bank's collateral analysis to gain recoveries from specialty collateral such as vehicles or tax refunds. Creditor committees may also give greater scrutiny to administrative costs and priority claims to ensure that these claims are administered accurately and appropriately. In addition, unsecured creditors may seek litigation claims against secured lenders, on behalf of the estate, to enhance recoveries.

**Derrough:** A creditor may look to litigation in an attempt to enhance its recoveries. We have seen certain unsecured creditors objecting to the treatment of other creditors. We have also seen investigations of transactions based on fraudulent conveyance allegations. Certainly, when an unsecured creditor group is offered zero recovery, you can usually expect litigation to follow. Successful actions that uncovered smoking guns, or just ammunition lying on the floor, has convinced more enhanced unsecured creditors that litigation is a legitimate approach to enhancing recoveries. Our view is that you can avoid litigation by cutting a deal that includes these groups. If that's at all possible, you may reach a faster and less costly outcome.

**Sprayregen:** What developments have you seen in the commercial real estate market? Has there been an increase in ►



**commercial mortgage-backed securities (CMBS) workouts?**

**Derrough:** The prevalence of the CMBS product as a financing vehicle throughout the real estate world is a frustrating, complicating factor. It's important in every restructuring situation to decide how to allocate the value, as well as the pain, fairly among the constituents without jeopardising the overall restructuring. Sometimes the desire to be fair ends up complicating the process and handicapping you when CMBS vehicles are involved. As an example, most CMBS vehicles are structured through real estate mortgage investment conduits, or REMICs. Those vehicles are not allowed to own equity interests, only debt and cash. That restricts the ability to allocate equity among similarly situated creditors in a company. So, it is important to anticipate these challenges and create mechanisms and structures that are suitable.

**Ziman:** There has been a considerable increase in CMBS workouts and I expect that trend to continue. Despite some rebound in late 2009 and 2010, a substantial amount of commercial real estate remains burdened by excessive leverage. I also see most of the future workouts in this sector, like the majority of those achieved to date, being effected outside of bankruptcy through the state-law mechanisms established by the CMBS documentation. 'Bad boy' recourse carveouts provided by deal sponsors virtually preclude voluntary bankruptcy filings, and to-date creditors have shied away from testing the 'no-bankruptcy' pledge in intercreditor agreements. It will be interesting to see what impact, if any, the events currently unfolding around Stuyvesant Town/Peter Cooper Village will have on the use of bankruptcy in the CMBS construct.

**Chatz:** It is my current experience that lenders in the commercial real estate market are working with their borrowers on forbearance agreements or extensions, particularly where cash flows facilitate the payment of interest and at times, reduction of indebtedness notwithstanding valuations that may be less than the indebtedness due to the lender. Difficulties still remain in dealing with CMBS structure and obtaining relief for debtors or even obtaining access to those who may be able to assist.

**Strochak:** There continues to be distress all through the commercial real estate markets in the US, affecting traditional mortgage loans as well as loans that have been securitised in the CMBS markets. The April 2009 Chapter 11 filing of General Growth Properties, the country's number two owner of shopping malls, shook up the CMBS markets and many participants feared a wave of similar cases. That hasn't materialised, primarily because lenders are agreeing to amend and extend loans before a Chapter 11

filing is necessary.

**Carson:** The CMBS sector has faced a downward credit-rating spiral and analysts expect increasing distress in the CMBS and banking industries due to the \$280bn in CMBS loans scheduled to mature in the next two years. Banks and investors have not been willing to write down assets if they have other options. For example, they have established special workout-servicing models to modify debt such as keeping assets in receivership; prohibiting modified amounts from exceeding loan amounts; and when loan-to-value is high, requiring escrows and reserves. Despite these strategies, it's clear that the sheer size of the CMBS market, combined with the unprecedented scheduled maturities-to-come, could bring a rising tide in the number of bankruptcy filings.

**Wolf:** The commercial real estate market has, of course, suffered devastating losses during the past two years. A very substantial part of my practice has always consisted of the representation of owners and developers of commercial real estate. To date, I have encountered no evidence of an uptick in this market. To the contrary, values continue to decline while defaults and foreclosures proliferate. The increase in the number of workouts and bankruptcies involving CMBS is both a logical and expected part of this trend. Moreover, this increase has brought into focus a number of new and challenging legal issues including, without limitation, the enforceability of contractual and other provisions purporting to preclude the borrower from commencing a bankruptcy case.

**Golubow:** In 2009 the Department of the Treasury issued tax regulations that make it easier for owners of distressed real property to restructure CMBS loans. For example, the Treasury now permits CMBS servicers to enter into modifications to extend the term of a securitised loan, even if that loan is currently performing and not in default. Previously, maturity date extensions could only be granted for loans that were in default or facing 'imminent default' without creating adverse tax implications for the real estate mortgage investment conduit that holds the securitised loan. Experts estimate that there are more than \$150bn of securitised loans that will mature between now and 2012, the vast majority of which won't qualify for refinancing assuming a financing source is even available. The regulations are in response to tremendous pressure from the real estate industry to respond to the illiquidity that plagues the capital markets and to allow loan servicers to modify loans prior to a monetary default where it is likely that the loan cannot and will not be repaid at maturity. While there has been plenty of talk of CMBS loan modifications, to date, few loans have been modified. Instead, CMBS loan servicers are predominantly pursuing liquidation strategies intended to yield the highest recovery on a net present value basis that includes foreclosure, deeds in lieu of foreclosure and sales of the underlying notes.

**Hammer:** In recent years – and particularly in this recession – traditional banks have provided very little financing for commercial real estate transactions, with insurance companies and high-yield offerings becoming more prevalent sources of capital in this market. Under the current economic climate, lenders are slowly coming to terms with the poor performances of their portfolios. And while foreclosure proceedings and deeds-in-lieu of foreclosure have been increasingly utilised by commercial real estate lenders, CMBS workouts have generally been more widespread and preferred to foreclosure remedies.

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BARRY A. CHATZ

**Sprayregen:** There seems to have been an uptick in Chapter 15 and cross-border restructuring activity. What do you believe are the reasons behind this? What additional challenges do these engagements present?

**Strochak:** As business becomes more global, it seems inevitable that we will see more Chapter 15 cases. There simply are more companies that need to avail themselves of the procedures Chapter 15 offers to protect assets in the United States. Cross-border cases often move more slowly than single-jurisdiction cases due to the heightened need for coordination between the courts. The fundamental problem in cross-border cases is reconciling what can be very different procedural and substantive rules that apply in different countries. The US focus on rehabilitation of troubled companies, the preference in US law for permitting company management to control the reorganisation process, often clashes with the creditor-protection bent of the law in many legal systems.

**Carson:** Chapter 15 cases have steadily climbed from 76 in 2006 to 147 proceedings in 2009. Businesses have become increasingly global in their operations and face a variety of challenges depending on the state of the financial markets in which they operate. As global companies seek corporate restructuring as a strategic approach, they traditionally have encountered legal challenges as each country has its own insolvency laws. Insolvency professionals increasingly have tested Chapter 15 as a more universal approach to cross-border insolvency matters. However, in recent Chapter 15 cases, we have seen challenges occur when the centre of main interests (COMI) are contested in cases involving offshore jurisdiction. COMI may change even after entering liquidation which can lead to unpredictability in the bankruptcy court's jurisdiction to enforce foreign orders under Chapter 15.

**Wolf:** The simple, although slightly 'smart-alecky', answer is that Chapter 15 did not exist until 2005 and the worldwide recession hit in 2008. Hence the uptick in cases. While the enactment of Chapter 15 was definitely a major step in the right direction, the additional challenges and complications are manifold. Perhaps necessarily, Chapter 15 provides only a bare skeletal framework for dealing with cross-border insolvencies. With the passage of time, both Congress and the bankruptcy courts will put some additional meat on the bones of Chapter 15. The jurisprudence in this area is still being developed. A bigger problem, perhaps, is that which arises from the vast inconsistencies in the insolvency laws of the various nations, and the absence of treaties allowing trading partners to achieve their reasonable commercial expectations.

**Hammer:** Economic globalisation and integration has vastly increased the number of companies that operate, own assets, or otherwise conduct business in multiple countries. The rise in Chapter 15 filings can be attributed to globalisation, coupled with the economic crises and unavailability of credit that has occurred on a national and global level. While there seems to have been an uptick in cross-border restructuring activity, international insolvency proceedings, such as Chapter 15 of the Bankruptcy Code, are still underutilised. Indeed, many jurisdictions in the US still have not handled a Chapter 15 bankruptcy proceeding, which has created a deficit in precedent to guide practitioners. Cross-border insolvencies are inherently complex given the conflicting laws of multiple jurisdictions, and these proceedings are further complicated by the uncertainty created from this underutilisation.

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NEAL L. WOLF

**Chatz:** The desire to assure orderly liquidations of companies with global footprints will lead to an increase in the utilisation of Chapter 15. The challenges presented by these circumstances are interlacing the laws of the United States with the laws of other countries and making sure that assets are preserved and values are maximised, notwithstanding what may be archaic or less than efficient laws relating to bankruptcy in other countries.

**Ziman:** Cross-border matters raise a variety of challenges. The immediate problem is dealing with the application of different reorganisation schemes to various aspects of a business. In many respects this has become more complicated as businesses tend to be managed on a global 'line-of-business' basis and less with regard to national borders. If there are companion proceedings in other jurisdictions, it is critical to develop functioning working relationships between or among the various courts or tribunals and with the foreign administrators or monitors commonly appointed in non-US proceedings. If there are no non-US proceedings, it is imperative to protect foreign assets (often among a multinational's most valuable) from remedies by local creditors or even US-based creditors that benefit from foreign guarantees.

**Golubow:** The ever-increasing integration of the world's economies has led to a steady increase in Chapter 15 cross-border insolvencies. But foreign-based corporations are experiencing several practical challenges while in Chapter 15. For example, they have at times been unable to bind some foreign entities and lenders to the terms of a US bankruptcy court order or a confirmed plan. Intransigent foreign creditors at times file independent claims against foreign subsidiaries in foreign jurisdictions with the knowledge that they cannot always be controlled by US bankruptcy law, and in some cases they will be paid in full as their goodwill is often required to complete the restructuring of the foreign corporation.

**Derrough:** We can expect to see more cross-border cases, especially with European companies filing for Chapter 11 in the US. These companies will seek to essentially avoid foreign processes if possible. The power of the automatic stay and the contempt of court threat for anyone who violates the automatic stay, is one of the most powerful tools available to a company anywhere in the world. In terms of Chapter 15, I think people will be fairly cautious about conducting true parallel proceedings with judges in two separate countries trying to work together. Sometimes this judicial process has worked. Where it hasn't, it's usually because of two different administrative procedures.

**Sprayregen:** Looking ahead, what prevailing trends do you expect to see in restructuring solutions and bankruptcy pro- ➤

**cesses? What are your thoughts on the impact of a possible double-dip recession and the maturing of leveraged debt obligations in years to come?**

**Hammer:** Although the credit freeze is beginning to thaw for some markets, access to capital is still limited for many companies in bankruptcy proceedings. A double-dip recession and the maturing of leveraged debt obligations will do little to further loosen credit markets, and we anticipate that debtor-in-possession and bankruptcy exit financing will remain scarce in the near term. As a result, we do not expect a return to ‘traditional’ Chapter 11 reorganisations for the foreseeable future, although out-of-court restructuring and liquidation activity should remain at its relatively high current level for some time.

**Derrough:** Unfortunately, there is still far too much leverage out there in the system; not enough of it came out. In many ways, what has allowed Wall Street and therefore the markets to recover after the fall of Lehman and the end of 2008, has been inflationary monetary policy at the central banks. But with no real improvement in credit quality, we have not seen a wholesale deleveraging of the corporate world the way that we might have expected. That lack of deleveraging is not just confined to the corporate world – it’s on a global basis. It includes governments and government sponsored entities that have tremendous amounts of debt. The policy set by central banks and finance and treasury ministries may have put us back on our feet, but there is still widespread underlying sickness out there.

**Carson:** Corporate restructuring will continue to serve as a strategic approach to help companies resolve balance sheet and operational issues. In an uncertain economy, corporate debtors need to seek efficient solutions in navigating the bankruptcy process. They will continue to rely upon technology and specialised service providers to support the administration of claims, to manage the involvement of public-securities holders and provide more efficient case administration from the onset of the case through to its conclusion. As for the impact from a possible double-dip recession and from the forthcoming ‘wall of debt’, current economic forecasts indicate that either of these events would inevitably place additional financial pressure on businesses, resulting in an uptick in corporate defaults and Chapter 11 filings. In sum, the approaching ‘wall of debt’ combined with higher taxes, financial reform, and potentially higher interest rates, contribute to an optimistic outlook for sustained corporate restructuring activity in years to come.

**Ziman:** I expect that the trend of ‘less is more’ will continue. By that I mean less time in Chapter 11 and more time executing restructurings out of court or, if in-court, on a pre-packaged or pre-negotiated basis wherever possible. Distressed companies will continue to be pressured to have an exit strategy in hand upon filing and that may generate considerable valuation litigation. The ‘wall of debt’ maturities simply will not move for some companies and restructurings will inevitably occur. Precisely the form those restructurings will take remains to be seen but given the magnitude of the investments for many private equity firms I would anticipate that the first choice will be some form of new value pre-packaged plans. A significant challenge for those deal sponsors will be convincing the holders of the fulcrum securities why they (the sponsor) should be able to participate in any new money investment. It will certainly be interesting to see how the tail end of the ‘debt bubble’ plays out.

**Wolf:** One trend that should continue and expand is the development of an increasingly coherent and consistent international regime for the handling of cross-border bankruptcies and insolvencies. This trend is presaged by, among other things, the adoption of a comprehensive bankruptcy regime (that borrows heavily from the American and British systems) by the People’s Republic of China and the openness of recently liberated Eastern European countries to the Anglo-American model. My initial thought regarding the impact of a possible double-dip recession and the maturing of leveraged debt obligations is that bankruptcy experts are going to be very busy.

**Chatz:** It is rather likely that the current liquidation based ‘restructurings’ will continue for the foreseeable future. It is unclear if capital markets will exist to fund reorganisations of any kind. I am particularly concerned with the increase in numbers of consumer filings throughout the country, as well as my experience that the nature of those filers reflects significant job loss and reduction of earning capacity. There appears to me to be an inherent deflation in earnings of the middle class within the United States and impact of this circumstance cannot be contemplated at this time. Taking the consumer circumstance into the calculus as well as the maturation of leverage debt obligations that appear to be coming due in the next number of years and the lack of liquidity in the markets to refinance the same, and further adding to this potential tsunami, the lack of revenues received by State and local governments due to erosion in property values and otherwise, I am very concerned that the economic market place is not stabilising and further business and job loss will continue without the ability to restructure or reset the same.

**Strochak:** The Chapter 11 process in the US had proven very flexible and many companies now accomplish transactions in Chapter 11 that previously were thought too complex and risky to achieve in a court-supervised environment. An example is the re-listing of shares of General Growth Properties on the New York Stock Exchange during its Chapter 11 case and pursuit of a complex equity investment and spinoff transaction to finance the company’s emergence from Chapter 11, both unprecedented in Chapter 11 practice. We will continue to see more ‘firsts’ like these in Chapter 11 cases. As for the effect of general economic conditions, continued high unemployment in the US will create challenges for many businesses regardless whether the economy actually dips back into recession. Upcoming debt maturities in 2012 and 2013 present significant hurdles for business and it does not appear now that there will be adequate capacity to refinance it all, likely requiring increased restructuring activity in these years.

**Golubow:** In the foreseeable future, debtors-in-possession will continue to have limited access to capital thereby forcing pre-petition lenders to provide post-petition loans in order to maximise their return on investment. Also, the dearth of capital available to Chapter 11 debtors will result in pre-packaged bankruptcies and quick liquidating 11s. As the world economy begins to emerge from the financial downturn, viable businesses will have greater access to capital, and more companies will be able to consummate the more traditional bankruptcy reorganisation. A double dip recession would lead to a renewed credit crunch and liquidity issues. However, companies should be more resilient than the initial recession experienced in the Great Recession of 2008-2009 because companies have become far more conservative than previously, have tried to learn from the Great Recession and have substantially de-leveraged. ■



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