As the wheel turns: new dynamics in the coming restructuring cycle

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Although predictions are inherently risky, even a cursory review of recent business headlines in the United States might raise the question whether, after years of increasing leverage and frenetic private equity activity, corporate restructuring is on the threshold of a resurgence. If so, the next cycle of US bankruptcies and restructurings is likely to be measurably different from – and considerably more contentious than – prior cycles.

The business environment in which future corporate insolvencies will be resolved has fundamentally changed in recent years. Derivatives and other financial innovations now allow investors easily to 'participate out' their stakes as creditors. Corporate debt – senior and junior, secured and unsecured, bank and bond – is now both widely held and rapidly traded by sophisticated investors. A highly liquid market for distressed debt and bankruptcy claims has resulted in an extraordinary turnover of creditors of companies in financial distress, and non-traditional unregulated investors (especially hedge funds) are increasingly among the largest and most active creditors of troubled firms. During the same period, merger and acquisition (M&A) activity in relation to troubled firms, much of it led by private equity firms, has grown enormously.

These business developments are likely to have two overarching consequences for Chapter 11 practitioners:

- Increased focus on acquiring control of the Chapter 11 debtor – the processes of reorganising and selling a distressed company will increasingly merge into a single process, with creditors effectively playing the same role as shareholders of a solvent enterprise by retaining or selling the company (whichever they perceive to be to their greatest advantage). Even where the debtor's business is not sold outright, claims trading by activist investors often results in a contest for control of the debtor through the reorganisation process itself. Either way, the filing of a Chapter 11 petition now puts the debtor in play, regardless of whether it is being reorganised or sold.
- Increased bankruptcy litigation – at least in the short term, many Chapter 11 cases (particularly those where the debtor is in a particularly acute stage of financial distress) will become fluid and often contentious affairs, with disparate creditor constituencies often taking aggressive positions in court in order to defend and advance their interests while the debtor is in play. The prevalence of second, and even third and fourth, lien debt, and the attendant complexity of having multiple groups with secured creditor rights, will be a primary driver on this front.

These dynamics will have significant practical implications for restructurings in the near future. However, in order to understand them better, it is instructive to review their root causes.

Claims trading and distressed investing have created new Chapter 11 players

Twenty-five years ago significant bankruptcy claims (other than public bonds in some situations) rarely changed hands. The major creditor participants in corporate reorganisations were usually large commercial banks and other institutional creditors (eg, insurance companies), indenture trustees representing bondholders and the debtors' vendors. Institutional creditors were largely par investors, which were not obliged to mark their investments to market. They were often slow to recognise losses and, for a number of regulatory and accounting reasons, were often reluctant to convert their debt to equity. Indenture trustees had no direct exposure, and often preferred to be directed by a court than to make decisions that could expose them to criticism or liability. Vendors' main interests were in future business and, although seeking to maximise their own recoveries, they were often far more focused on keeping the goose alive so it could continue to provide them with future business.

However, in 1991 Rule 3001 of the Federal Rules of Bankruptcy Procedure was amended to make it easier to buy and sell bankruptcy claims without court approval. Although trading activity in bankruptcy claims at all levels of troubled companies' capital structures (including senior secured claims) started as a trickle – with mostly opportunistic financial investors at first – it quickly became a flood. Today, almost every major US financial institution has a well-staffed distressed desk and the number of unregulated investment entities (ie, hedge funds) specialising in distressed strategies has ballooned.

Moreover, as the market for bankruptcy claims has grown, the investment horizons of market participants have diversified. Those purchasing claims soon after the amendment of Rule 3001 often viewed their investments as short-term trading positions. However, in recent years many claims purchasers have taken a longer-term approach, analogous to that of private equity investors. Such investors often buy and hold claims through the reorganisation process with the objective of acquiring a stake in, or control of, what they believe will be the fulcrum class of claims – that is, the class where they expect the equity value of the enterprise to reside after the reorganisation is complete, based on their estimate of the value of the business and the legal priority of the claims they are purchasing relative to the priority of other claims. Such long-term buyers are now common and, through the vehicle of creditors' committees (both official and unofficial), are increasingly involved in the debtor's day-to-day business decisions and the selection of management and the future board of directors even before a reorganisation plan has been agreed.

In recent years the buy-to-own strategy of purchasing bankruptcy claims in order to acquire control of large bankrupt companies has been brought to bear at increasingly large and prominent corporate debtors, including:

- Kmart, acquired by ESL Investments through the purchase of bonds and bank debt;
- XO Communications, acquired by Carl Icahn through the purchase of senior secured debt and senior notes; and
- Burlington Industries, acquired by Wilbur Ross in an auction after having purchased a significant portion of the company's unsecured bonds and bank debt.

The market for distressed assets is larger than ever

Historically it was believed that insolvent enterprises were difficult to sell for full value. Some corporate debtors were thought to be too large to be sold for a fair price in a thin and non-competitive market for corporate acquisitions. It was also thought that, in many cases, a 'taint' would be associated with an insolvent business that would force a severe discount on its intrinsic value.

This is no longer the case. The depth and breadth of today's M&A and financing markets means that the size of the distressed business is no longer a constraint on sale. Strategic and financial buyers compete fiercely with each other for corporate assets and the capital markets provide ready access to the capital required to consummate transactions of almost any size. Moreover, as bankruptcy sales have become more common and competition for distressed assets has grown, buyers have become less likely to impose an insolvency discount in connection with such a sale. Indeed, the ability of a Chapter 11 sale order to cleanse assets of contingent liabilities and other claims may well enhance the synergy value of the assets, so as to permit Chapter 11 sales at a premium to what the debtor could sell its business for outside bankruptcy.

The attitudes of bankruptcy courts towards sales have also evolved. The Bankruptcy Code has always permitted the sale of the debtor's business free of pre-bankruptcy creditors' claims, either

pursuant to a court order under Section 363 of the Bankruptcy Code or as part of a duly approved Chapter 11 reorganisation plan. However, at present bankruptcy judges are increasingly willing to entertain a sale of a debtor's entire business under Section 363. They are also less willing to tolerate delaying tactics by out-of-the-money classes that could thwart a value-maximising sale. As bankruptcy judges have become more amenable to the sale of a debtor's business, the case law with respect to such sales has become increasingly hospitable to such sales.

In 2007 the Sixth Circuit joined the Third and Fourth Circuits and other courts in holding that in certain circumstances asset sales carried out pursuant to Section 363 of the Bankruptcy Code may limit or preclude later claims brought by creditors against the asset purchaser based on state law theories of successor liability (see *Al Perry Enterprises, Inc v Appalachian Fuels LLC*, 503 F 3d 538 (6th Cir 2007); *In re Trans World Airlines, Inc* 322 F 3d 283 (3d Cir 2003); *In re Leckie Smokeless* 99 F 3d 573 (4th Cir 1996)).

In addition, the *sub rosa* plan doctrine has declined. Bankruptcy courts have generally become more liberal in interpreting the Bankruptcy Code's requirements to permit approval of sales of substantially all of a debtor's assets pursuant to Section 363 before confirmation of a Chapter 11 reorganisation. Although the standards for such sales differ somewhat from one judicial circuit to another, the courts have generally moved away from requiring a showing of an emergency need to sell the business and require only a "sound business justification" for selling the business in advance of a reorganisation plan.

This does not mean that an insolvent debtor's value will always be maximised by a bankruptcy sale, or that the capital markets will always make available the funds necessary to make a value-maximising sale possible. However, it does mean that the sale of a distressed business today is more likely to maximise value than previously. Sales are increasingly viewed by creditors as a viable option that should be taken seriously by debtors and have become an increasingly common feature of the Chapter 11 landscape. According to one study, more than half of all large Chapter 11 cases result in sale of the debtor's business (see Douglas G Baird and Robert K Rasmussen, "Chapter 11 at Twilight", 56 *Stanford Law Review* 673, 675 (2003), citing figures for 2002).

Frequently such sales involve not closing down the business and liquidating its assets, but rather selling the business as a going concern. Strategic and financial buyers compete in a process that resembles a conventional M&A auction, with formal, typically court-approved bidding procedures and break-up fees. Even the most substantial Chapter 11 sales (eg, the recent sale of Adelphia Communications to Time-Warner and Comcast for $17.6 billion – $12.7 billion in cash and 16 per cent of the common stock of Time-Warner Cable) can be consummated using such procedures. Other well-known companies that have sold either all or a material portion of their assets through similar court-supervised procedures include Polaroid, Bethlehem Steel, Loral Space & Communications, US Airways, Delphi Corporation and Dura Automotive Systems.

Creditors are increasingly pushing new alternatives for value creation

The flexibility to choose between transferring control through a negotiated reorganisation and selling the business offers creditors the same type of 'hold or sell' decision that shareholders of solvent companies face every day in the marketplace. As in the non-bankruptcy context, the debtor's creditors will have a range of views regarding whether they should continue to own an interest in the company or sell it. Those investors that want to sell have the freedom to do so by selling their claims in the market, rather than waiting for the entire company to be sold. This means that, while a Chapter 11 case is pending, claims in the fulcrum class will tend to migrate into the hands of investors that are more likely to take a strategic view of their interest in the company. In addition, with increasing frequency financial investors seek control of distressed companies through the claims trading mechanism rather than through a Chapter 11 sale of the entire business, and Chapter 11 sales will more likely occur when there is a buyer for which the business has special synergy value.

In situations where active claims trading has created aggregations of control positions in a relatively small number of hands, Chapter 11 plan negotiations will increasingly resemble negotiations among private equity buyers, with negotiations over post-bankruptcy corporate governance (eg, who controls the board of directors) and control over when and how to sell the equity of the reorganised enterprise (eg, registration rights, tag-along rights and drag-along rights) becoming increasingly important. In such situations, the reorganisation process will often

begin well in advance of the Chapter 11 filing, possibly with the negotiation of a pre-packaged or pre-negotiated reorganisation plan.

Several practical consequences of these dynamics are expected. In addition to the expected increase in Chapter 11 sales, the use of rights offerings in connection with a debtor's emergence from Chapter 11 should increase, particularly in cases where claims trading values become depressed, including backstops by well-heeled creditors. Rights offerings allow savvy distressed investors to purchase equity at favourable prices because some creditors continue to want cash rather than equity for their claims. Creditors that desire cash can exit and creditors that want more equity can obtain it. Rights offerings also provide a mechanism for further delevering the debtor's post-emergence balance sheet. To the extent that the terms of proposed rights offerings (eg, fees paid to backstop providers, creditor constituencies eligible to participate) are controversial among creditor groups, rights offerings may become the cause of significant inter-creditor litigation. Recent bankruptcies where such rights offerings have been employed include Bally Total Fitness, Dura Automotive Systems, Silicon Graphics, Delphi Corporation and Northwest Airlines.

Creation of a fluid and often contentious court environment

Chapter 11 has proven surprisingly effective at mediating competing financial interests in a way that permits an orderly and increasingly speedy transition in control of the enterprise. Looking to the future, it is expected that, as Chapter 11 evolves into a forum by which sophisticated players in an increasingly liquid claims market resolve financial distress through the change of control of a troubled enterprise, the court environment will become increasingly dynamic. This is likely for a number of reasons.

Recent legislative amendments and financial innovations will increase the uncertainty of the Chapter 11 landscape and encourage litigation

As recent bankruptcies have shown, in general, new participants in today's corporate reorganisations – particularly hedge funds and other distressed investors – are not averse to using the Chapter 11 process to assert and litigate their perceived rights. Where competing groups of creditors are present, such litigations can be particularly hard fought and exceedingly expensive. For example, the Adelphia Communications reorganisation lasted over five years due to infighting among at least 12 unofficial groups of creditors, resulting in seven proposed reorganisation plans and multiple appeals. The reimbursement for professional fees and expenses that was initially sought by these 12 groups alone totalled over $100 million.

Increased legal uncertainty in the next generation of Chapter 11 cases will, at least initially, only worsen the risk of such internecine bankruptcy disputes among creditors. Looking to the future, there are several possible sources of such legal uncertainty.

In 2005 Congress implemented extensive amendments to the Bankruptcy Code. The legislative amendments to Chapter 11 were drafted with varying clarity and may, after judicial interpretation, rebalance the dynamics of Chapter 11 and/or provide certain kinds of creditor with improved or favoured treatment. In the next Chapter 11 cycle, the courts will need to consider the implications of the following legislative amendments:

- The previously often-extended exclusivity period during which a Chapter 11 debtor has the exclusive right to file a reorganisation plan now may not be extended beyond a date that is 18 months after the bankruptcy petition date. This amendment may empower creditor constituencies to seek to delay the reorganisation process in the hope of proposing their own alternative plans.
- Severe limitations on severance and compensation for executives may result in leadership vacuums at some debtors.
- Any claim for goods received by a Chapter 11 debtor in the 20 days prior to the date of the Chapter 11 petition date is now entitled to administrative expense priority and the reclamation period has been extended. This amendment could have a material liquidity impact on some debtors.
- Utilities now find it easier to demand large cash deposits from Chapter 11 debtors. This amendment could materially increase the working capital requirements of some corporate debtors during Chapter 11.

Creditors and their advocacy groups are expected to litigate aggressively to secure favourable precedents interpreting these and other amendments implemented by the 2005 legislation.

The uncertainty caused by relatively new

legislation is compounded by the fact that the financial marketplace has witnessed tremendous recent growth in legal and financial structures whose bankruptcy implications have not been rigorously tested by modern bankruptcy courts. For example, between 2003 and 2006 the amount of second-lien loans (ie, loans secured by second liens on assets that are already fully encumbered in favour of first-lien lenders) grew from approximately $3 billion to $29.7 billion. Such loans, which are almost always made to already highly leveraged companies, frequently contain bankruptcy-related inter-creditor provisions of varying quality, the legal enforceability of which is disputed by some practitioners. Thus, the enforceability of these provisions may become the subject of hotly contested litigation between opposing camps of lenders during the next distressed cycle. Other structural innovations from the last decade are likely to be similarly tested by deep-pocketed investors.

Increased distress of Chapter 11 debtors will complicate the process of reorganisation

Many companies entering Chapter 11 in the future may be weaker and less viable than they were in the past. At least one recent study has suggested that large companies filing for Chapter 11 relief in recent years have been more deeply distressed than past corporate debtors (see Barry E Adler, Vedran Capkun and Lawrence A Weiss, *Destruction of Value in the New Era of Chapter 11*, October 24 2006, at 10). There is at least anecdotal evidence to suggest that this phenomenon will worsen in the wake of the recently ended credit boom due to:

- the increased leverage incurred by many corporate borrowers as an alternative to restructuring troubled operations; and
- the increased use of 'covenant-lite' structures – that is, debt with few or no triggers to alert investors to the need for, and triggers to force, the restructuring of a company in financial distress.

The prevalence of more highly leveraged balance sheets, coupled with a delay in restructuring efforts (whether outside or in Chapter 11), will leave companies with fewer options once they are finally compelled to face reality and restructure. Among other things, such companies are less likely to have free assets or enterprise value available to secure additional financing or to provide adequate protection to existing secured creditors as they seek to finance themselves under Chapter 11. The code's limitations on the use of cash collateral and on the ability to grant priming liens to debtor-in-possession lenders in the absence of adequate protection may well make it difficult or impossible to reorganise without the consent and cooperation of secured creditors.

Another dynamic that requires observation is the loan-to-own phenomenon, whereby an investor makes a loan with the understanding that the loan may not be repaid but rather converted at some future date into equity in the reorganised company. For example, in the Radnor Holdings bankruptcy Tennenbaum Capital Partners was alleged to have used such a loan-to-own strategy to take control of a borrower shortly after it filed for Chapter 11. Although unsecured creditors sought to prosecute numerous causes of action against Tennenbaum (including the equitable subordination and/or disallowance of Tennenbaum's bankruptcy claims), the bankruptcy court ruled in favour of Tennenbaum in all respects (see *In re Radnor Holdings Corporation*, Case 06-50909-PJW, Bankr D Del November 17 2006).

Secured lenders or purchasers of senior claims whose objective is to acquire a controlling stake in a reorganised enterprise may well take a counterintuitive approach to reorganisation bargaining. Rather than pressing for a sale as a senior creditor would have in the past, such a purchaser may press for a reorganisation based on a conservative valuation of the business that results in the allocation of all or substantially all of the equity of the reorganised debtor to the senior class, leaving little or nothing for junior classes. Junior creditors or equity holders will counter by either contesting the reorganisation valuation in court or pressing for an auction of the business, attempting to prove that the valuation advocated by the senior class is unduly low. As litigation in the Adelphia Communications bankruptcy illustrated, such disputes among creditors can be incredibly complicated and costly.

Many creditors will be invisible to corporate debtors

In the next wave of Chapter 11 cases it may be difficult for debtors and other parties to identify the parties with which to negotiate due to the prevalence of claims trading and because nominal holders of claims are increasingly participating out or hedging their exposures (using outright participations or swaps). As a result, the apparent creditors of the troubled firm may not be the real

parties in interest or even have the decision-making authority with respect to the claims they appear to own. This makes it increasingly difficult to communicate with the ultimate decision makers in the creditor body in order to negotiate a restructuring. This may make representative bodies (eg, official and unofficial creditors' committees) the focal point for reorganisation negotiations and at the same time make the behaviour of creditors (whose true exposures may differ from appearances) less predictable.

An additional complication in terms of counterparty identity is posed by the unregulated character of hedge funds, which are increasingly prominent in today's corporate reorganisations. Such investors frequently seek to influence the reorganisation process through membership on unofficial committees, which allow them and similarly minded investors to pool resources and share professional fee costs. One recent area of conflict is Bankruptcy Rule 2019, which requires that "every entity or committee representing more than one creditor or equity security holder… shall file a verified statement" that discloses:

- the name and address of each member;
- the nature of the creditor's claim and the date of acquisition; and
- the amounts paid for the claim.

Many practitioners have argued that, as committees, unofficial committees have a legal obligation under Rule 2019 to disclose publicly the identities of their members and the relevant facts surrounding their members' financial interests in the bankrupt company.

On the other hand, the distressed investing community has argued that forcing such public disclosures on distressed investors will compromise the confidentiality of their proprietary trading strategies and will ultimately discourage investors from investing in bankruptcy claims. The issue has also divided the only two bankruptcy courts that have recently confronted it; in 2007 a New York bankruptcy court ruled that an unofficial committee in the Northwest Airlines bankruptcy was subject to the requirements of Rule 2019, while a Texas bankruptcy court ruling just three weeks later found that an unofficial committee in the Scotia Development bankruptcy was not subject to the requirements of Rule 2019. Regardless of how this controversy is ultimately resolved, it serves to highlight the tensions emerging as the new business paradigm comes into conflict with core principles of traditional bankruptcy practice.

Many creditors will have multiple personalities

Some creditors are hedging themselves by purchasing claims at multiple levels of the debtor's capital structure, a trend that, at least in a bankruptcy context, can create behavioural anomalies. Some investors have used their rights (eg, to vote) in one class of claims to benefit their position in another class. For example, members of senior lender groups now frequently decline to receive company information so they can remain unrestricted and capable of purchasing and selling public subordinated debt. In some recent cases, only a handful of senior lenders have been willing to receive non-public information, making it impossible to include the vast majority of lenders in reorganisation plan negotiations. Creditors are also sometimes found to be substantial investors in other companies in the same industry as the debtor, arguably giving them divided loyalties and causing them to engage in even more unpredictable behaviour.

Such conflicts may come into increasing focus during the next Chapter 11 cycle and, in addition to slowing the overall pace of Chapter 11 cases, may expose individual creditors to bankruptcy litigation, including equitable subordination attacks or vote designation actions seeking to deprive them of their ability to vote on a reorganisation plan.

Many creditors will be financially distressed

Debtors with creditors which are themselves in financial distress, thus distorting their behaviour as creditors, are increasingly likely. This phenomenon has already appeared to some extent in industries with multi-level supply chains, such as automotive parts. It is also likely to surface as the diversity of creditors grows. As situations such as Amaranth and Long Term Capital Management suggest, unregulated investors can suddenly find themselves in financial difficulty and their actions to protect their positions can create a ripple effect in the market. When such entities have investments in insolvent companies, they may find it more difficult to make rational choices about restructuring their investments. Such entities may well dump their positions, abruptly changing the pricing and ownership of claims. This phenomenon may offer bargains to those with the capital to purchase, but it also has the potential to disrupt the restructurings and Chapter 11 cases of companies in which the selling entities are invested.

Comment

It remains to be seen how all these trends will play out in the new, market-driven Chapter 11 environment. However, one thing is clear: the new environment presents opportunities and risks that differ from those experienced in prior cycles, and the lessons from these new opportunities and risks are yet to be experienced and learned by investors and professionals alike.