THE STRATEGIC VIEW

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Corporate Restructuring 2016

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Corporate Restructuring 2016

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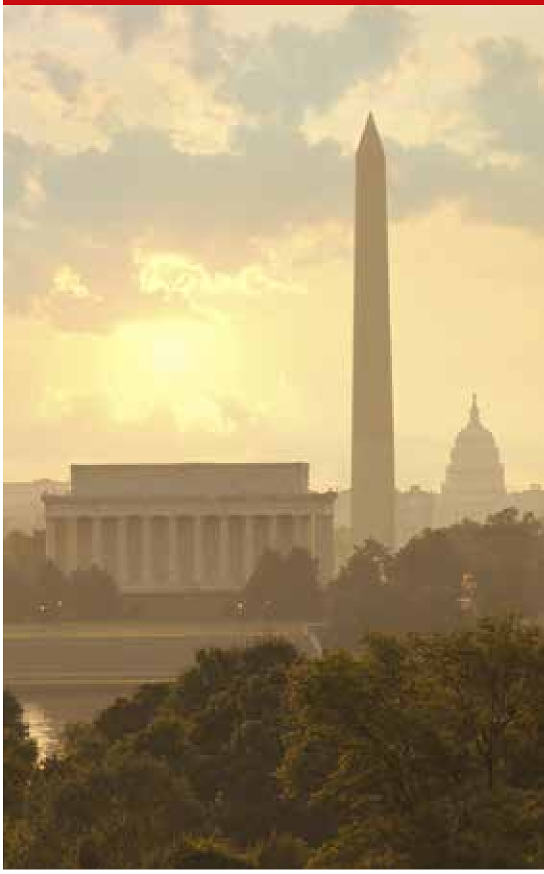

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Alan Kornberg and Brian Hermann discuss the various restructuring options available in the United States and suggest discrete changes to enhance the efficiency and eliminate the ambiguity of the current legal framework.

1. What trends, in terms of activity levels, affected industries or investor focus, have you seen in the restructuring and insolvency market in your jurisdiction over the last 12 months?

Over the last 12 months, default rates and filing rates for U.S. bankruptcy cases have remained low. U.S. restructuring activity has increased but is largely concentrated within the oil and gas, mining and metals sectors. Distress in these sectors has been exacerbated by weak demand, plummeting prices, industry-specific legacy liabilities and increasing regulatory pressure and costs. Oil and gas and coal companies have been among the hardest hit, leading many such companies to begin restructuring discussions with creditors, implement out-of-court restructurings or commence U.S. bankruptcy cases.

2. What is the market view on prospects for the coming year?

Industry-specific (rather than economy-wide) distress is likely to continue to drive restructuring work in 2016. Sectors that struggled in 2015 (*e.g.*, oil and gas, mining and metals) will likely continue to experience distress in 2016 as current market conditions are not expected to change in the short term. For example, coal and oil prices are not forecast to rebound meaningfully (if at all) in the near or medium term. Companies in these industries, many of which have highly levered balance sheets, likely will continue to need to restructure.

3. What are the key tools available in your jurisdiction to achieve a corporate restructuring are they primarily formal, court-driven processes, or are informal out-of-court restructurings possible? Do you feel that the tools you have available are effective in terms of providing speedy, fair and predictable outcomes?

A number of in-court and out-of-court restructuring options exist in the United States. The "best" or most "effective" restructuring tool may vary depending upon, among other things, a company's restructuring goals, capital structure, public shareholders, rehabilitation prospects, relationships with key creditor constituencies, and other company-specific variables.

Out-of-court options are often contractual in nature (*e.g.*, debt modification, debt repurchase, debt-for-equity, new equity), although other mechanisms (such as informal wind-downs) may be available in some cases. A company's ability to execute an out-of-court restructuring is generally case specific: Is the proposed transaction permitted under the relevant debt documents? If not, can the debtor obtain the consents required under the relevant agreements or, if applicable (or incorporated by reference), the Trust Indenture Act of 1939 (the "TIA"), to pursue the transaction?

Out-of-court restructurings often proceed more quickly than full-blown chapter 11 cases and involve lower administrative costs and less adverse publicity, management diversion and implementation risk than court-supervised restructurings. However, recent decisions construing mandatory voting provisions (and unanimous consent requirements) in the TIA have created uncertainty regarding a company's ability to effectuate non-unanimous out-of-court transactions, even if contractual approval thresholds have been satisfied. As a consequence, the leverage afforded to holdouts may make some out-of-court restructurings more contentious, expensive and difficult to consummate.

In addition, out-of-court restructurings may not provide effective or complete relief in all cases. For example, if a company requires operational relief or needs to shed legacy liabilities (such as pension or OPEB liabilities), it will likely need to commence a court-supervised proceeding.

A number of court-driven processes are available. Chapter 11 is generally the process for restructuring a company, although it may also be used to effectuate a liquidation. (Chapter 7 is the primary liquidation procedure.) Chapter 15 provides a procedure for recognising – and obtaining relief ancillary to – a foreign insolvency or restructuring proceeding.

Chapter 11 cases come in a variety of flavours, reflecting, among other things, the extent to which the debtor has control over the filing and has secured the support of key creditor constituencies. A company may commence a voluntary case (i) without securing the support of any creditors (a so-called "free fall" case), (ii) after reaching agreement with major stakeholders on the terms of a restructuring but before soliciting votes on a plan of reorganisation (a so-called "pre-arranged" or "pre-negotiated" case), or (iii) after reaching agreement with creditors and soliciting votes on a plan of reorganisation (a so-called "pre-packaged" case).

Creditors meeting certain statutory eligibility requirements may commence an involuntary case under chapter 11 (or chapter 7) by filing a petition. If the petition is not timely contested, the court will order relief. However, if the petition is contested, the creditors must establish that the debtor is generally not paying its debts as they come due unless such debts are disputed, or that a custodian was appointed within 120 days of the petition date. If a foreign insolvency or restructuring proceeding is pending against a debtor, the foreign representative appointed in such proceeding may also file an involuntary petition.

The costs in a free-fall case (voluntary or involuntary) can be substantial and the timing and ultimate outcome can be difficult to predict, particularly in contentious cases. Pre-packaged and pre-arranged filings combine many of the best aspects of an out-of-court restructuring – cost efficiency, speed, flexibility and cooperation – with the binding effect and structure of a court-supervised proceeding. However, as with any court-supervised process, the outcome is not guaranteed. The proceeding is subject to oversight by (and input from) a number of parties (*e.g.*, the court, official and unofficial committees, and the U.S. Trustee) and parties in interest have the opportunity (and a forum in which) to object.

4. In terms of intercreditor dynamics, where does the balance of power lie as between shareholders and creditors, and as between senior lenders and junior/mezzanine lenders? In particular, how do valuation disputes between different stakeholders tend to play out?

Intercreditor or interstakeholder disputes often play out in, or against the backdrop of, a court-supervised proceeding. (Remedies are rarely enforced outside of bankruptcy – most sophisticated borrowers will file for bankruptcy to automatically stay enforcement actions.) In recent years, full-blown valuation disputes between stakeholders have become less common. Intercreditor disputes instead tend to focus on clawing back alleged fraudulent conveyances, chipping away at the size of creditors' claims (*e.g.*, challenging

> We would propose a few discrete changes [to the legal framework] to enhance efficiency and eliminate ambiguity

creditors' rights to make-wholes and interest) or disputing the validity or perfection of liens.

5. Have there been any changes in the capital structure of companies based in your jurisdiction over recent years caused by the retreat of banks from loan origination? In particular, have you found that capital structures now increasingly comprise debt governed by different laws (such as New York law governed high yield bonds)? If so, how do you expect these changes to impact restructurings in the future?

Most loan documents for U.S. companies (and some non-U.S. companies) are governed by New York law. While banks continue to arrange and syndicate these loans, the banks (and the agents under the facilities) often no longer hold meaningful positions. As a result, borrowers generally cannot fall back on their relationships with banks (or negotiate with agents) to obtain waivers, amendments or other relief. They instead negotiate with *ad hoc* groups – self-selected, and sometimes quite diverse, groups of debtholders (ranging from par holders to hedge funds).

6. Is there significant activity on the part of distressed debt funds in your jurisdiction? How successful have they been in entering the market, and how much has market practice (or law) evolved in response? If funds have not successfully entered the market, can you identify reasons why?

Distressed debt funds play a major role in nearly every high-profile restructuring in the United States. Distressed debt funds often purchase debt on the secondary market, purchase and sell claims in chapter 11 cases and originate prepetition and postpetition loans to companies. Distressed debt funds with cross-holdings, hedging positions or unique investment strategies may have different objectives than seemingly similarly situated creditors; negotiating consensual restructurings in this environment may be challenging. Some commentators (and judges) have expressed concern that distressed debt funds are seeking to use their postpetition financing arrangements with debtors (and leverage obtained as secured creditors) to advance aggressive loan-to-own strategies and control the pace and/or direction of cases.

7. Are there any unusual features of your insolvency or restructuring law that an external investor should be aware of (such as equitable subordination, or substantive consolidation)?

The Bankruptcy Code and the case law that has developed around it include a number of provisions and rights that may impact investors and creditors. We highlight a few below.

Under U.S. bankruptcy law, a secured creditor may "credit bid" its claim when its collateral is sold in a bankruptcy case, i.e. a secured creditor may purchase its collateral in full or partial satisfaction of its secured claim against the debtor. This right, which is incorporated into the Bankruptcy Code, reduces a lender's need for liquidity at the time of the sale and may ensure the collateral is not sold for less than the amount of the lender's secured claim.

A Bankruptcy Court may "equitably subordinate" a creditor's claim to other claims (in essence, lower the priority of that claim) upon a showing that the claimant engaged in inequitable conduct that harmed other creditors or conferred an unfair advantage on the claimant. Often, the practical result of equitable subordination is that the subordinated claim will not receive any distributions on account thereof.

A Bankruptcy Court may also "designate" (*i.e.*, disqualify or disallow) the vote of a creditor on a plan of reorganisation if the vote was not given or obtained in good faith (*e.g.*, the creditor is seeking to obtain an advantage not available to similarly situated creditors or further an agenda that doesn't relate to its claim). Vote designation does not prevent a creditor from receiving distributions on account of its claim – it merely prevents such creditor from voting on a plan. Parties sometimes seek to designate the votes of creditors who purchase claims for the purpose of pursuing a specific objective separate and apart from maximising the value of the purchased claims. While vote designation is not unprecedented, it is not common.

Under certain circumstances, the Bankruptcy Code permits a Bankruptcy Court to effectively merge the estates of two or more distinct debtors (and sometimes, the estate of a debtor and a non-debtor) into one for purposes of distributing assets. Known as "substantive consolidation", the doctrine results in the two estates sharing assets and liabilities and the extinguishment of duplicate claims between debtors. By pooling the assets of, and claims against, two or more entities, substantive consolidation eliminates any structural priority between the claimants of the consolidated entities. Thus, for example,

- where a creditor of the subsidiary company had structural priority over a creditor of such subsidiary's parent holding company, upon substantive consolidation of the two companies, the parent creditor's claim would be structurally equal to the similarly situated claims of the subsidiary's creditors. As a result, both creditors of the parent and subsidiary share in the value of both companies equally. Courts will generally only order the substantive consolidation of a group of debtors if (i) creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) the affairs of the debtors are so entangled that consolidation will benefit all creditors.

In a chapter 11 case, a class of dissenting creditors may be crammed down under a plan of reorganisation over its objection if, among other things: (i) at least one impaired class votes in favour of the plan (*i.e.*, creditors in the class holding a majority in number and two-thirds in amount of claims that are actually voted accept the plan); and (ii) the plan (1) does not discriminate unfairly, and (2) is "fair and equitable". A plan does not unfairly discriminate if there is no disparity in treatment among creditors within the same class of claims.

A plan is fair and equitable if it complies with the absolute priority rule. With respect to secured creditors, members of the class must: (i) retain their liens and receive deferred payments with a value equal to the allowed amount of their secured claims, valued as of the effective date of the plan; (ii) receive the proceeds from the sale of their collateral, if such property is to be sold, including the right to a credit bid at any such sale; or (iii) receive the "indubitable equivalent" of their secured claims. A plan is fair and equitable with respect to unsecured creditors if the members of the class receive property of a value equal to the allowed amount of their unsecured claims, or if such class is not paid in full, no junior class will receive any estate property under the plan.

8. Are there any proposals for reform of the legal framework that governs insolvency and restructurings in your jurisdiction?

In 2011, the American Bankruptcy Institute (a nonpartisan organisation of bankruptcy professionals, judges and turnaround specialists) organised a Commission (the "Commission") to study the reform of chapter 11. In December 2014, the Commission published a lengthy report setting forth recommendations. Among the recommendations were: (i) subjecting to heightened scrutiny attempts to sell substantially all of a company's assets in the first 60 days of a bankruptcy case; (ii) permitting a court, under certain circumstances, to disband or prohibit the appointment of a statutory creditors' committee; and (iii) making it more difficult for prepetition debt to be repaid through debtor-in-possession financing facilities.

In October 2015, the Loan Syndications and Trading Association (the "LSTA") (a trade association that represents members involved in the origination, syndication, and trading of commercial loans) issued a response to the Commission's report; the response took issue with the Commission's general approach to bankruptcy reform, as well as a number of the Commission's specific proposals. The LSTA maintained that the bulk of the Commission's proposals with respect to creditors' rights would harm, rather than help, debtors, creditors and the credit market.

The extent to which Congress will consider and, ultimately, adopt and codify the Commission's recommendations remains to be seen. The Commission was not organised or created by Congress and its recommendations are not effective absent congressional action. No clear timeframe or path for the reform of legislation exists.

9. If it was up to you, what changes would you make?

We would propose a few discrete changes to enhance efficiency and eliminate ambiguity.

The role and scope of responsibilities of an unofficial creditors' committee should be revisited, particularly in light of the prevalence today of *ad hoc* creditor groups, in many cases comprising the key stakeholders. Although not estate fiduciaries, these *ad hoc* creditor groups often are the best-situated and most motivated parties to maximise the value of the debtor's estate and, in turn, creditor recoveries. We agree with the Commission that revisiting the role and responsibilities of an official committee in such circumstances would reduce or eliminate redundancy and save valuable – and quite often limited – estate resources.

The Bankruptcy Code should also be amended to clarify what the appropriate "cramdown" interest rate is with respect to secured claims. As noted above, with respect to secured claims, a plan does not discriminate unfairly and is fair and equitable if the secured creditor retains its liens on the assets securing its claim and receives deferred cash payments with a present value of at least the collateral securing its claim. To compensate a secured creditor for the delay, any deferred cash payments must include interest on the secured claim. The proper rate of such "cramdown" interest, however, is unsettled. Courts have adopted varying approaches to calculate the cramdown rate of interest. The Bankruptcy Code should be amended to specify the applicable rate.

The Bankruptcy Code statute of limitations for fraudulent conveyance actions also warrants further consideration. Under the Bankruptcy

Code, a debtor may avoid a transfer of property that is voidable under state or federal law by a creditor holding an unsecured claim. Thus, a debtor may step into the shoes of an unsecured creditor to claw back property of the estate. Because the statute of limitations for fraudulent conveyance actions by the Internal Revenue Service is ten years – *i.e.*, longer than the limitations period under virtually any other statute –some courts have held that a debtor may "step into the shoes" of the IRS and assert fraudulent conveyance actions even if the applicable state law and Bankruptcy Code statutes of limitations with respect to the transfer have expired. This provision is too easily subject to abuse in this context – we suspect contrary to Congressional intent – and should be amended.

Finally, as noted above, recent decisions have created uncertainty regarding the construction and application of the TIA's mandatory unanimous consent provisions. The TIA should be amended to clarify what types of out-of-court transactions require the unanimous consent of debt holders.

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