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ROUNDTABLE

US BANKRUPTCY

A general financial malaise has swept across almost all sectors in the US. But a lack of available financing has damaged restructuring options, making liquidations and distressed sales more common. Debtors are denied the flexible reorganisation possibilities that exist under the US system, and which marked previous downturns. And since restructuring waves tend to build even after an economy recovers, there is a long road ahead.

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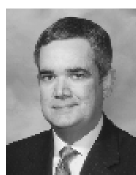

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Sprayregen: How would you describe the US bankruptcy market in the last 12-18 months? And in terms of the restructuring cycle, is the worst over?

Lonstein: The words 'historic' and 'unprecedented' have not been overused to describe the past 12 to 18 months in the US economy. Naturally, this has translated into the US bankruptcy market with a sharp rise in business filings, including the mega bankruptcy cases of Lehman Brothers, Chrysler, and GM. Lending virtually disappeared in the second half of 2008 and first quarter of 2009, resulting in a broad range of companies facing liquidity crises and the inability to refinance their debts or meet working capital needs. The lack of credit in turn resulted in a rash of bankruptcy liquidations and a contagion of Section 363 sales for many companies unable to obtain debtor-in-possession financing as well as the rise of the pre-packaged bankruptcy for the lucky few companies able to reach deals with their creditors to restructure their debts quickly. The traditional model for Chapter 11 standalone reorganisations just about disappeared during this timeframe. While there seems to be a strain of optimism emerging based on the second quarter 2009 GDP results, expected to reflect a lower rate of contraction in the last quarter, it appears that this optimism may simply be a case of 'recession fatigue'. There is no growth driver evident on the horizon, other than the government. And yet, even as we begin to see the benefits of government intervention in some sectors of the economy, many are worried about what will happen when the stimulus is withdrawn and US consumers are still on life support. In sum, while the relatively worst part of the crisis may be behind us, the road ahead is fraught with challenges.

Darby: In the past 18 months, professionals in the US bankruptcy market have gone from looking for a glass of water to trying to drink from a fire hose. I do not believe the worst is over. In general, bankruptcy is a lagging indicator to the economy. Some commentators recently have noted hopeful signs in the economy. Evidence of a real turn in the economy is not apparent to me. But even if the economy picks up in the near term, many firms have entered the restructuring pipeline and will need time to work through their problems. Media attention often focuses on large cases and developments in the financial markets, but many businesses in other sectors are in distress. Although individual cases are smaller, this is where most Americans have jobs and where the greater part of the economy works. We expect to be dealing with the effect of the financial crisis on the 'real economy' for the foreseeable future.

Rapisardi: The past 18 months have been historic, both with respect to the companies that have sought bankruptcy protection and the complexities presented by their filings. I think it is important to note that the number of bankruptcy filings will not always peak at the bottom of a recession. Chapter 11 filings may increase toward the tail end of a recession, when financial institutions become increasingly willing to provide debtor-in-possession and exit financing. Therefore, while we may not see filings of the magnitude and with the historical significance of Lyondell, Lehman, GM and Chrysler in 2010, the number of Chapter 11 filings will not necessarily decrease.

Owsley: The recession started more than 18 months ago, but defaults did not really kick in until less than a year ago. Most restructuring professionals only began to get busier from that point forward. There is a lag where defaults tend to continue well after the economy nominally turns up. In this cycle we are also seeing something different because many troubled companies are owned by private equity firms. Many buyouts were covenant-lite, allowing the underlying company to continue walking like a zombie, without having to face defaults or restructurings for another year or more. Private equity firms want to preserve the status quo, keeping existing bank debt in place because it is cheap financing. They recognise that they may be underwater from their equity investment but that they have option value and control value, and are prepared to wait for a positive development down the road. Commercial real estate is another area that will take several years to play out. Of course, private equity firms are also facing new challenges when their liquidity-constrained portfolio companies require fresh capital, and the private equity firms do not want to invest further below 'Mt Debt'; we have seen a slew of private equity firms seek help in right-sizing portfolio companies' balance sheets in such circumstances.

> **The US bankruptcy market has been busy with some of the largest Chapter 11s ever having been filed in the last 18 months, including Lehman Brothers, General Motors and Lyondell Chemical.**
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> JOHN S. MAIRO

Hammer: Driven by the global credit crisis and low consumer demand, the US bankruptcy market has become increasingly active over the past 18 months, with commercial bankruptcies having jumped 42 percent in July 2009 over the same period last year. It is unlikely that the 'worst' is over. The fortunes of many industries – particularly retail, hospitality, aviation and automotive – are tied to US consumer spending, which basically went 'on strike' after the financial markets crashed in late 2008. Yet many businesses elected against filing for Chapter 11 because DIP financing was not available or they had no exit strategy. And those companies that dared to file for Chapter 11, like retailer Circuit City, ultimately liquidated. Nevertheless as DIP financing becomes more available, which appears to be happening, we should see further increases in large and mid-cap Chapter 11 cases over the next 18-24 months.

Mairo: The US bankruptcy market has been busy with some of the largest Chapter 11s ever having been filed in the last 18 months, including Lehman Brothers, General Motors and Lyondell Chemical. These filings have put a further strain on businesses that were already in trouble and the fallout from that strain will continue to be felt in the near term. For example, the General Motors and Chrysler filings have put additional pressure on the numerous suppliers in the automotive industry. While some of these suppliers will be able to weather the storm, many will not. Additionally, the US healthcare industry and commercial real estate market are in distress. With healthcare, there have been several hospital bankruptcy filings in the New York/New Jersey region. I expect that trend to continue as government funding for these institutions decreases. Similarly, the commercial real estate market is in bad shape but there has not yet been a rash of bankruptcy filings related to it. Over the next 12-18 months, I expect more bankruptcy filings and workouts in the commercial real estate market.

Carson: A recent report stated that Chapter 11 bankruptcies more ▸▸

than doubled in the last 18 months. This report illustrates the vibrant bankruptcy market we find ourselves in today. This current cycle reaches across all industries, such as retail, automotive, finance, homebuilding and manufacturing. In terms of the restructuring cycle, Moody's reported over $190bn in distressed debt scheduled to mature over the next three years; an indication that the worst isn't over. Not only has the private sector experienced challenges, US bankruptcy courts struggle to manage the increasing caseloads and look to hire more bankruptcy judges for support. Legal professionals and administrative-outsource providers continue to increase operational capacity to stay ahead of the cycle. It's difficult to pinpoint where we're at in the cycle, but we can expect a continued rise in Chapter 11 filings in the near future.

Chatz: The United States bankruptcy market in the last 12-18 months is a liquidation based marketplace. There is no 'restructuring cycle' of note. The cycle instead is based upon liquidation of assets for the benefit of secured lenders or debt restructurings which lead to the diminution of value for the benefit of equity holders, as well as subordinated debt holders. There are no traditional restructuring scenarios in the marketplace due to the diminution in value of collateral.

Sprayregen: How would you characterise the macroeconomic trends that are currently affecting businesses? Are these common to both medium and large-cap companies?

Hammer: Despite the recent modest improvement in our credit markets, the dominant macroeconomic trend affecting corporate America is the continued credit crisis. Excessive risk aversion also now dominates the psyche of consumers and businesses seeking merely to weather the storm. Another trend is the shift from deregulation to greater government intervention in the economy (case in point, the federal bailout of our financial community and the government-driven bankruptcies of Chrysler and General Motors). While many could have predicted more economic regulation by the Obama administration, the unprecedented actions of the Bush administration to stabilise the monetary system in late 2008 illustrates the fragility of the global economic system. Finally, it is worth noting that the current economic malaise is equally affecting medium and large-cap companies. As credit starts to flow, large-caps with good balance sheets should fare best. Mid- and small-caps will survive as a class and should present the best distressed investing opportunities.

Carson: According to Bloomberg, the seizure in the financial markets triggered $1.52 trillion of credit losses and record-breaking unemployment rates, thrusting the global economy into a recession in 2008. This perfect storm of corporate and consumer decline continues to pose significant challenges for companies of all sizes. Businesses face limited availability of capital due to challenged credit markets and decreased consumer spending, a symptom of rising unemployment and declining consumer confidence. Further, businesses have failed to refinance the unprecedented amount of leveraged debt issued over the past decade. As a result, we see the impact of a recession on medium and large-cap companies across virtually every industry and the residual effects on the global economy. These effects continue to appear pronounced for all companies that struggle to compete for scarce rescue financing and seek opportunities to weather the storm.

Darby: The macroeconomic trends translate into fairly simple concepts for businesses: low revenues and scarce liquidity. Sales suffer from low consumer demand, high unemployment, business contraction and cost-cutting. The overabundance of capital in the earlier years of this decade has amplified the effect of the current credit crunch. For many years, firms were able to paper over inefficiencies and flaws in their business plans by tapping seemingly bottomless sources of funds in the capital markets. In addition to over-leveraging, businesses were able to avoid or postpone hard decisions through easy financing. Now that underwriting standards have swung far back in the other direction, many companies find their options extremely limited.

Owsley: Consumers are arguably in worse shape than they have ever been. They are scared, downbeat, over-levered and worried about losing their jobs. They have seen their net worth eroded and are getting zero income on savings. At the same time they are looking at the deficit and realising that they have to pay for it. I'm not very sanguine about consumers on a sustainable basis reaching anything close to their historical spending pattern. We see aberrations such as 'Cash for Clunkers' and other incentive programs, but I think those are short-lived. Personally, I believe inflation is coming like a freight train. It will have a material impact on companies and strategies going forward. All things being equal, large companies will naturally have greater staying power simply because of their size and access to capital sources. Having said that, in this cycle many big companies are dramatically overleveraged, which can swamp other effects.

Mairo: Lack of credit availability and lower consumer spending are trends that are negatively impacting both medium and large-cap companies. These trends create a kind of 'perfect storm' for many businesses in that their revenue is declining due to consumers spending less and the businesses are having a difficult time finding credit (or capital investments) to weather the storm.

Lonstein: I think everyone has burned their macroeconomic text books at this stage. It doesn't appear that any sector of the economy has been spared from the impact of this recession. The economic triumvirate of auto, retail and housing have all been affected by this recession as have companies large and small. Indeed, even those allegedly 'too big to fail' would likely have failed but for government intervention. Size is not as important as the degree of leverage at both medium and large cap companies. Those with lower leverage and access to working capital will naturally have a better chance of withstanding a prolonged decline in revenues on account of a consumer led recession. Also, those companies that prove themselves nimble in reducing their operating costs to come into line with declining revenues have a chance of emerging as winners.

Businesses face limited availability of capital due to challenged credit markets and decreased consumer spending, a symptom of rising unemployment and declining consumer confidence.

JONATHAN CARSON

Sprayregen: Which sectors have been particularly affected by

Many retailers are even more leveraged than they were before, and the advent of second liens has made it even more difficult for them to refinance.

HENRY OWSLEY

the financial crisis? How effective have reorganisations been in mitigating theses affects?

Chatz: Every sector in the economy is affected by the financial crisis. This includes service providers, manufacturers, healthcare entities and retailers. The next wave of distress may in fact be in the healthcare area, due to the lack of solvency of governmental entities and their inability to pay for the services that their constituents wish. But there are no reorganisations, only liquidations, and therefore reorganisation is not a mitigating factor whatsoever.

Lonstein: We have seen a broad wave of restructurings affecting auto, retail, home builders, mortgage lenders, casinos, ethanol plants, and packaging companies, among others, due to the financial crisis and industry specific factors. Of course, among these, the auto sector has been severely hit and prominently featured in the national news with Chrysler and GM in the spotlight. In the case of the latter two, we have seen reorganisation techniques, namely the 363 sale process, mitigate the effects of the crisis by at least providing a mechanism to preserve jobs and the prospect of a viable entity. However, many auto suppliers are still in the lurch struggling to restructure or facing the prospect of liquidation. In the retail and other sectors, where financing is scarce and no government intervention is feasible, reorganisations are not likely and therefore cannot mitigate the effects of the crisis. Instead, we see a rash of liquidations.

Owsley: In the financial sector, one of the first things to go was the mortgage insurers – and they have not yet recovered. Other types of insurers took risks that created significant problems, such as AIG. Essentially, any institution that had anything to do with backing derivatives experienced trouble on some level. Going forward, many players that we have not heard about – regional banks and other institutions that made significant loans to the commercial real estate market – are going to disappear. In terms of reorganisations, the financial sector is in a different category because regulators are responsible for winding down the books. Whether the decision is to trade paper or put in additional money, regulators will review proposals in terms of how they affect the interests of policyholders, and some regulators do a better job than others. In the last half of 2008, it was difficult getting money for anything. Now that the total meltdown is off the table, money is available at a certain price for most worthwhile assets – but it is not the easy money that preceded the credit crunch. As a final note, the whipping boy in every restructuring cycle is retail. The difference this cycle is that we are seeing more liquidations. Many retailers are even more leveraged than they were before, and the advent of second liens has made it even more difficult for them to refinance.

Darby: The real estate sector still is the primary victim of the financial crisis, but the ripples have spread across most sectors. The collapse of residential real estate caused many developers, construction firms and suppliers, and others in the building trades, to hit the wall in late 2007. Now the crisis has moved into commercial real estate and the commercial and industrial sector. The recession has devastated sales tax and property tax collections for many state and municipal governments. Local governments are a primary driver of the economy. There is a real danger of a spiral effect as plunging retail sales and property values limit jobs and infrastructure spending by local governments, which further may depress hiring, spending and residential sales.

Hammer: The early 2000s saw both housing and credit bubbles that burst over the last few years, notably affecting the financial, retail and automotive sectors, among many others. In the financial sector, many financial institutions have already repaid their government bailouts, but the verdict is still out on whether the systemic problems of the financial sector have been adequately resolved, particularly among community and regional banks. Turning to the retail sector, with drastically reduced consumer spending, national retailers like Sharper Image, Circuit City and Linens 'n Things accepted their fate and liquidated in efficient Chapter 11 proceedings. But without legislative reform, the prospect of significant retailer reorganisations in the future remains slim. Finally, in the automotive sector, inflation in raw material costs, weak consumer spending and nagging legacy costs each contributed to the overall structural weakness in this sector. In the end, Chrysler and General Motors responded by liquidating their assets under Chapter 11, with their successors supposedly being 'better, faster and stronger' than their predecessors.

Mairo: To date, the financial crisis has particularly impacted the retail and automotive sectors. As consumers have spent less, many retail chains have filed for bankruptcy protection and attempted to reorganise. However 'reorganising' has not really occurred for a variety of reasons, and many of these retail businesses have simply liquidated in one form or another, often selling substantially all of their assets to a competitor through the bankruptcy proceedings. The automotive sector has also been greatly impacted with manufacturers and suppliers filing for bankruptcy. While the GM and Chrysler cases have resulted in government sponsored Section 363 sales, they were more akin to reorganisations than many of the retail cases. For example, GM used the bankruptcy and sale process to modify its collective bargaining agreements, close some manufacturing facilities and reject many dealership agreements.

Carson: Due to the systemic nature of the financial crisis, nearly every sector has been adversely affected, including automotive, homebuilding, manufacturing, real estate and retail. With the decrease in consumer spending, the retail industry looked to Chapter 11 for a lifeline. Unfortunately, due in large part to strict timeframes on lease assumptions and rejections mandated by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), many retail companies were unable to restructure their debt obligations and have undergone liquidation. On the flipside, the manufacturing sector, not subject to lease issues, has mitigated the effects of the financial crisis through Chapter 11 and consolidation. Automakers continue to utilise Chapter 11 as a mechanism for organised asset sales with government-sponsored support. In general, Chapter 11 reorganisation serves as a strategic alternative for distressed companies to navigate through tough economic times, maximise recoveries and return to profitability.

Rapisardi: The current financial crisis has affected US automobile manufacturers, as well as auto parts suppliers. General Motors and Chrysler will serve for years to come as landmark bankruptcy cases. In both cases, the companies sold their assets through expedited Section 363 sales, which enabled the companies to exit bankruptcy in less than 45 days, thereby minimising the risks and costs associated with multi-year proceedings. In addition to the automobile industry, a significant number of printing companies have filed Chapter 11 petitions within the past two years, including Press Ex, R.H. Donnelley, Quebecor World, American Color Graphics and Vertis. While Quebecor World's recent emergence from bankruptcy suggests that printing companies may effectively restructure existing debt through Chapter 11, the larger economic issues effecting this industry will continue to affect printing companies after they exit bankruptcy. Finally, the American gaming industry has been devastated by the recent recession. Recent gaming company filings include Tropicana Entertainment LLC in May 2008 and Trump Entertainment Resorts, Inc. in January 2009. Several other gaming companies, such as Harrah's Entertainment Inc. and MGM Mirage, have sponsored debt exchanges, sold assets, and renegotiated credit agreements in order to avoid Chapter 11.

Sprayregen: How has the bankruptcy and reorganisation process changed in this downturn, and how has this affected the market for corporate restructurings?

Darby: The lack of liquidity in the capital markets limits asset sales and financing, the lifeblood of bankruptcy reorganisation. Troubled firms are hard-pressed to find financing to support their restructuring efforts, exit financing for troubled loans, and buyers with financing ready to make going-concern purchases. This limits the options for corporate restructurings both in and out of bankruptcy. A unique feature of this downturn is that a workout or Chapter 11 case may feature not just one financially distressed company but two: the borrower and the lender. Few of us have much experience in negotiating a workout for a troubled borrower when the lender also is a candidate for Chapter 11.

Hammer: This bankruptcy cycle has differed substantially from past cycles in that DIP financing remains largely unavailable. It also represents the first significant period of business bankruptcies following the implementation of the BAPCPA, which many US restructuring professionals believe impaired corporate reorganisations, particularly among large retailers. Given the unavailability of DIP financing and BAPCPA's challenges, many potential debtors elected not to file for Chapter 11. Instead, they embraced less costly alternatives such as out-of-court workouts, receiverships and state law liquidations. Thus, while Chapter 11s certainly have increased, Chapter 11 activity across the country is still not as robust as economic conditions suggest, especially outside of popular venues for Chapter 11s such as Delaware and New York.

Given the unavailability of DIP financing and BAPCPA's challenges, many potential debtors elected not to file for Chapter 11. Instead, they embraced less costly alternatives.

AARON L. HAMMER

Mairo: Many companies have been unable to reorganise and are just liquidating because this prolonged downturn has made reorganising very difficult. The unavailability of exit financing has left some companies with little choice but to liquidate their assets. Also, the Chapter 11 process can be very expensive and many companies do not view reorganisation as a realistic alternative when their businesses continue to trend downwards and the credit markets remain tight. Consequently, many companies are trying to restructure their debts or receive concessions from their major creditors outside of a Chapter 11. On the bright side for troubled businesses, many lenders recognise the expense of a Chapter 11 proceeding and are willing to modify their debt facilities to keep the business from liquidating inside or outside a Chapter 11.

Lonstein: It remains a much noticed irony that businesses need substantial cash and access to capital in order to restructure, whether in or out of bankruptcy. And so in the recent environment, the banking crisis and resulting lack of credit has had an enormous impact in altering the timeline of reorganisation processes and strategies for survival. We have seen that companies without access to a debtor-in-possession facility are likely to liquidate quickly, sell their assets in a 363 sale, or hand over control of the business to creditors in a pre-packaged deal. We have also seen a dramatic rise in strategic acquisitions as savvy buyers swoop in to take advantage of opportunities to purchase assets from distressed sellers both in and out of bankruptcy proceedings. This trend is surely going to continue as opportunities increase. As the recession continues, more companies with sound business models are likely to have to seek bankruptcy protection on account of revenue declines and liquidity pressures, increasing opportunities for buyers to acquire distressed assets at attractive prices.

Carson: Today's corporate bankruptcies move at an accelerated pace and present more complexity than those in past economic downturns. Companies undergoing bankruptcy in the current market must contend with limited financing options, restrictions imposed by the BAPCPA, and increasingly complex capital structures as companies took on multiple layers and types of debt during the past decade. As a result, troubled businesses must approach corporate restructuring more strategically than ever. When possible, opting for pre-arranged and pre-packaged bankruptcies over the 'free-fall' bankruptcies seen in previous downturns to minimise costs and maximise recoveries. The increase in Section 363 asset sales signals another emerging strategy for companies to shed non-performing assets and liabilities via an organised Chapter 11 process. These new paradigms of bankruptcy serve as the rule and no longer the exception.

Rapisardi: One significant change in the reorganisation process has been a growing trend towards pre-packaged and pre-negotiated bankruptcies. The expense and complexity of traditional multi-year Chapter 11 reorganisations are motivating companies to reach pre-petition agreements with existing creditors and other parties-in-interest in order to expedite the reorganisation process. A second change worth noting is the increased reliance on Section 363 of the Bankruptcy Code. Section 363(f) allows a Chapter 11 debtor the opportunity to sell assets outside the ordinary course of business free and clear of existing third party interests and was, therefore, central to the GM and Chrysler restructurings. Traditionally, in order to sell assets

outside a plan of reorganisation, a debtor was required to demonstrate that an extreme emergency existed. However, recent jurisprudence suggests that such sales will be upheld provided that they are consistent with the exercise of sound business judgment. In addition, Section 363(k) grants secured lenders the ability to 'credit bid' during a bankruptcy sale. The credit bid allows a secured creditor's interest in an asset to serve as a benchmark for other bids and protects the secured creditor from a sale at a price less than the amount of the lender's secured claim. The importance of the rights created under Section 363(k) was recently evidenced in *In re Delphi Corp.*, where the debtors' DIP lenders effectively blocked a sale of the company's assets to a third party private equity firm after demonstrating that its proposal, which included the credit bidding of its secured debt, represented a higher and better offer for the estate.

Chatz: Traditional concepts of adequate protection – equity in assets which exceed the value of secured indebtedness lending and trickle down to unsecured creditors – are no longer part of the calculus. The current calculus is determining if there are any interested buyers with liquidity that are willing to pay a strike price for assets that is within the range of reasonableness for lenders and other parties. There are limited traditional battles regarding valuation and adequate protection for secured lenders.

Owsley: Chrysler and General Motors represent the two shining stars for how the government can completely twist the legal process to fit its own ends. In our opinion, the severe interpretation of the law in a way that did not exist before, coupled with the tactics that the government employed, changed the landscape. In the Chrysler case, there was a social policy to be met with respect to retiree pensions. But the bankruptcy law was effectively changed by mixing policies together to allow one constituency to jump ahead of another. It amounts to perverting a system that actually works pretty well in order to obtain public policies that could have been obtained through another mechanism. This could have wider repercussions. One of the things that we prize in the US is a belief in the rule of law. And if all of a sudden you change the rules and no one can tell you what the rule of law is, why would someone want to lend into this environment? This is one of many issues currently circulating which could easily hurt capital flows and the belief in contract enforcement in this country.

Sprayregen: What role are private equity, hedge funds and sovereign wealth funds playing in the reorganisation process, if any?

Rapisardi: Prior to the current recession, private equity and hedge funds were frequently providing financing to help companies avoid insolvency. This financing is commonly subordinate to traditional bank financing but ranks ahead of the interests of corporate bondholders against a company's assets. Recent Chapter 11 filings have placed these funds at odds with first-lien lenders and other creditor constituencies, often forcing them to defend the enforceability of their liens. In light of these challenges and recent perceived declines in asset values, these funds have understandably become more reluctant to take on second lien debt. Still, I believe they will play an increasingly active role in the DIP lending process in light of the protections afforded to DIP lenders under the Bankruptcy Code.

Hammer: Although private equity funds traditionally have been hesitant to invest in distressed situations, with the current wave of bankruptcies, these funds have increased their interest in distressed assets, with some reports estimating $51bn in cash earmarked for this class. Unlike many commercial banks without capital to invest, however, funds that 'sat on the sidelines' during the crash – as did many experienced distressed investors – are now flush with cash to invest in distressed or reorganising enterprises, often for control. We expect increases in distressed investments as economic conditions stabilise. Notable situations where 'activist' hedge funds have injected themselves into Chapter 11 processes for profit included Lehman Brothers and Chrysler. However, in these cases, the bankruptcy court ultimately stymied the funds' attempts to gain control or otherwise influence the proceedings. For instance, one hedge fund group in Chrysler raised myriad objections to the debtor's 'first day' motions until the presiding judge ordered the group to publicly disclose its members. Fearing the fallout, the group withdrew their opposition to the transaction.

> **Private equity and hedge funds with ready capital remain cautious about entering the market. Many managers are trying to time the bottom.**
>
> PATRICK DARBY

Mairo: Private equity and hedge funds have continued to play a significant role in the US reorganisation process. Often private equity and hedge funds are some of the debtor's largest creditors and have the ability to drive a restructuring plan or block it. Moreover, with credit markets remaining tight, these funds have the ability to provide liquidity to troubled companies. For example, when CIT was on the brink of bankruptcy last month it was their bondholders, many of which were hedge funds, which provided them with the liquidity to avoid (or delay) a bankruptcy filing.

Darby: Private equity and hedge funds with ready capital remain cautious about entering the market. Many managers are trying to time the bottom. When the market thinks we have touched bottom, a great deal of private capital currently on the sidelines will be available. This process is understandable; it also is a self-fulfilling prophecy. Investors can't determine values in the absence of a genuine market. Recently, we have begun to see signs that investor interest is picking up and a thaw may be setting in. The coming months will determine whether abundant private capital will assume the role of institutional lenders. Vulture investors are entering the market now, but it may be months or even years before mainstream players get back in the market.

Owsley: We are seeing two types of financial players: the 'haves' and the 'have-nots'. The 'have-nots' are focused on hanging on and maybe hitting a couple of home runs if their fortunes turn. They are in a very defensive position in terms of not putting out money, but they are offensive in terms of trying to maximise their recovery on their existing portfolio. The 'haves' are offensive in both ways; they are well capitalised and looking to take advantage of the current market. Given the kinds of long-term capital strategies being operated at the moment, it has become hard to tell the difference between hedge funds and private equity funds. But their contribution as a source of capital to the reorganisation process is uncertain. In many cases, an ▸▸

internal rework will provide more value to the bankruptcy constituencies than outside money, based on the rate of return these funds are seeking at the moment. It is not uncommon in this environment for internal values to far exceed any bids a company may receive. Funds are being extremely selective about their investments.

Lonstein: Many funds have been on the sidelines due to a number of factors. Some are facing their own internal redemption and liquidity pressures. Some have a lack of liquidity for certain investments that were traditionally attractive due to distressed prices and an active trading market. Others are hampered by the uncertainty created by the scale of government intervention in the credit and financial markets, not to mention in Chrysler and GM. Many were burned in early 2009 when they jumped in (in hindsight a bit early) to buy first lien secured debt at 60, only to see that same paper decrease to 30 due to the banking and liquidity crisis. Many are still waiting for a consensus to develop that we are at or near the much anticipated 'bottom'. I expect we will see some big players jump back in the second half of 2009 to take advantage of opportunities to acquire both distressed debt and assets or to provide much needed capital to fund restructurings.

Chatz: The roles of these alternative fund sources are limited to circumstances of large entities, or if (and only if) they can pay less than liquidation value for assets. Then the question is whether they even have the availability of cash to do so. There may be certain limited instances where parties may be interested in finding value in certain asset lines, but the majority of circumstances relate to mitigation of losses versus putting more assets into the marketplace.

Carson: At its peak, private equity served as a vehicle to build diverse business portfolios that spawned the largest leveraged buyouts, skyrocketed deal flow and delivered huge returns. In some instances, private equity brought capital and leverage to distressed companies to help them navigate a restructuring and end up owning the equity of the business (or a large part of it) upon the company's emergence from bankruptcy. Today, private equity finds itself focused on strategies to restructure financing and operations within portfolio companies to protect investments rather than fund new ventures. Hedge funds played an active role in investing in distressed businesses' capital structures over the last decade. Nowadays, hedge funds find themselves flush with opportunities to invest in troubled companies, whether buying into capital structures or serving as a lender. As the capital-market turbulence eases, hedge funds will continue to invest in new and creative ways in the distressed arena.

Sprayregen: To what extent have foreign debtors and their legal representation managed to utilise Chapter 15 of the Bankruptcy Code to further their cross-border reorganisations or liquidations?

Mairo: With the global recession and many foreign companies having assets and creditors in the US, foreign debtors and their advisers have successfully utilised Chapter 15 to further their cross-border proceedings. The Bankruptcy Court for the Southern District of New York has been the venue of choice for Chapter 15s. A common Chapter 15 scenario is that a foreign debtor has a pending foreign proceeding and wants the creditors in the US to, first, be bound by the orders entered in the foreign proceeding, and second, to be enjoined from taking actions against any assets located in the US. For example, in the ING Re: (UK) Limited case, the foreign representative of the debtor filed a Chapter 15 case in the Bankruptcy Court for the Southern District of New York to essentially achieve those two goals. Foreign insurer ING Re (UK) Limited had already initiated insolvency proceedings in England and its representative had proposed a Scheme of Arrangement for addressing creditors' claims. Through the Chapter 15, the ING Re (UK) Limited representative was able to obtain an order from the New York Bankruptcy Court which provided, among other things, that creditors in the US would be bound by the Scheme of Arrangement and enjoined from taking any action against ING Re (UK) Limited property in the US. With the exception, pursuant to Section 1501(d) of Bankruptcy Code, of any deposit, trust fund or the like posted by ING Re (UK) Limited under state law; however, once policyholders received payment under the Scheme, they would lose their contractual right to proceed against those funds and the banks holding the funds were permitted to return the funds to the foreign representative. I expect foreign representatives to continue to utilise Chapter 15 to further their foreign insolvency proceedings.

Rapisardi: As Chapter 15 was added under the BAPCPA in 2005, there is not an abundance of case law interpreting its various provisions. However, the distinction Chapter 15 draws between 'foreign main proceedings' (a bankruptcy proceeding pending in a country where a debtor's 'centre of main interests' are located) and 'foreign non-main proceedings' (a bankruptcy proceeding pending in a country where a debtor has 'an establishment' which is not its 'centre of main interest') is worthy of note and has been the subject of recent case law. While recognition of a foreign main proceeding triggers significant automatic relief as a matter of right, including the operation of the automatic stay, any relief requested following recognition of a foreign non-main proceeding is at the discretion of the Bankruptcy Court. A series of interesting cases involving hedge funds incorporated in the Cayman Islands suggests that funds largely operating in the United States, with offshore tax haven incorporation but few other connections to their place of incorporation, may not be able to gain foreign main proceeding recognition under Chapter 15 of the Bankruptcy Code.

Lonstein: Chapter 15 is still relatively new, having been added to the Code in 2005 in order to implement the US adaptation of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law. We have seen a steady increase in the use of Chapter 15 in 2008 and 2009 as an effective tool to facilitate cooperation and coordination between US bankruptcy courts and foreign courts, including to assist eligible foreign insolvency proceedings that have become more prevalent in a global economic downturn. Recent examples include the use of Chapter 15 for certain Nortel Networks and Lehman affiliates with foreign liquidation proceedings.

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CARMEN H. LONSTEIN

Hammer: Foreign representatives have increasingly relied on Chapter 15 over the past 12 months, but the chapter is still underutilised in cross-border corporate restructurings and liquidations given its potential. Although Chapter 15 was implemented under BAPCPA in 2005, many districts outside of New York and Delaware still have not administered a Chapter 15 proceeding. This reality has led to a dearth of Chapter 15 case law and unfamiliarity with the process among bankruptcy courts. Professionals representing clients in cross-border matters also tend to rely on Chapter 11, which is more familiar but ultimately more costly to administer than Chapter 15s. As more professionals open themselves to the possibilities of Chapter 15 proceedings, we should see more of them in this cycle.

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

Owsley: Leaving GM and Chrysler aside, 363 is a powerful tool, and in this environment we are seeing that more and more. Institutions are threatening foreclosure, or friendly foreclosure, more than in the past. Also, private equity firms are much more aggressive in dealing with predator constituencies than they have been in the past. Private equity's theory is that, whereas they may have let the nickels and quarters drop to the floor in previous downturns, they now need to pick up whatever nickels and quarters they can because there is nothing else.

Rapisardi: I would expect the increase in pre-packaged and pre-negotiated bankruptcies to continue. I also believe that Section 363 will play a central role in an increasing number of bankruptcy cases. In fact, in its opinion on an appeal raised in *Chrysler*, the Second Circuit Court of Appeals noted that sales under Section 363 have become commonplace in large corporate restructurings, often allowing a debtor to receive maximum value for its assets, and may 'replace the main route of Chapter 11 reorganisation plans' in the near future.

Hammer: In a sharp contrast to previous business bankruptcy cycles, the current cycle consists primarily of debtors looking to quickly unload substantially all of their assets through a Section 363 auction process, or to orderly liquidate their estates and wind-down their businesses. The number of successful reorganisations in the last 12 months is relatively small and tend to involve pre-packaged or pre-negotiated transactions. As the credit markets thaw and start to address the needs of financially distressed companies, we anticipate a shift towards companies using Chapter 11 to further operational and financial restructurings similar to the last significant bankruptcy cycle in the early 2000s but with an increasing reliance on pre-packaged or pre-negotiated transactions. In this current cycle, however, advances in bankruptcy case administration and technologies offered by third-party bankruptcy claims agents should facilitate more efficient Chapter 11s in middle market cases that traditionally might not have supported a claims agent. Whether jurisdictions outside of Delaware and New York will experience greater volumes of Chapter 11s remains a big question.

Carson: Given the distressed outlook for the US and the world economy, the corporate restructuring industry will impart a new breed of bankruptcy solutions and processes to respond to the needs of troubled businesses and the professionals who advise them. With the rise in pre-packaged bankruptcies and 363 asset sales, we can look forward to defined approaches and innovative solutions to serve as a roadmap for the future. The dual pre-pack merger between American Color Graphics and Vertis is one example of how companies can creatively utilise Chapter 11 as a strategy and a model for addressing similar challenges. In addition, today's thriving restructuring industry will enhance bankruptcy professionals' methods of devising creative solutions and navigating extensive processes to ensure successful outcomes. Professionals will look to outsource providers, such as claims agents, specialised bankruptcy consultants and others, for efficient case-administration solutions to remain focused on the substantive matters of corporate restructuring cases.

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JOHN J. RAPISARDI

Lonstein: The prevailing trend of accommodating expedited distressed sale transactions in order to preserve jobs and the viability of an enterprise through Section 363 sales is likely to continue. Also, we will likely continue to see an increased focus on out-of-court restructuring solutions and pre-packaged bankruptcies that avoid the large transaction costs associated with the typical pre-crisis model for the US Chapter 11 process, particularly where no debtor-in-possession financing is available. We are also likely to see a rise in pre-packaged liquidation plans as companies simply shut down in order to implement an orderly liquidation process for the benefit of all constituencies.

Mairo: I expect the trend of fewer Chapter 11 reorganisations and more Section 363 asset sales to continue. With credit remaining tight and the Chapter 11 process remaining expensive, many companies will attempt to restructure their debts outside of the bankruptcy court. Along those same lines, if a bankruptcy filing becomes necessary to bind recalcitrant creditors, I expect that companies will strive during the pre-bankruptcy time period to formulate pre-packaged Chapter 11 plans which have the support of a majority of their creditors. While Section 363 sales have always been viewed as an efficient, beneficial way to sell assets, there seems to be a growing trend of companies filing for bankruptcy with no intention of reorganising but instead to effectuate a Section 363 sale transaction. Another trend is greater involvement of foreign entities in US bankruptcy cases. With more US businesses having a global market and with many US businesses relying upon overseas manufacturing, US bankruptcy cases will continue to ensnare foreign entities.

Darby: Without a ready market for either exit financing or sales of businesses as going concerns, borrowers and lenders will be forced to choose between structured liquidation and old-fashioned debt restructuring. Institutional lenders are extremely hesitant to double down by advancing more funds to support a distressed credit. To a greater extent than in the past, institutional lenders are selling loans to investors with different collection strategies. As the liquidity crisis eases, we expect to see a continuation of the trend towards Chapter 11 as a mechanism to facilitate going-concern sales and 'loan to own' transactions. Bargains are available for those with cash. The sale process for GM and Chrysler is not likely to repeat itself without extraordinary involvement by the White House, but those bankrupt- ►►

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cies presumably have put to rest the notion that Chapter 11 precludes a quick asset sale in lieu of a plan of reorganisation.

Chatz: The prevailing trends for the end of 2009 appear to be the continued liquidation of business assets due to the lack of sales of goods and services and continued lay-offs of employees in the marketplace. There also appears to be a general reduction in income which is leading to further lack of demand, notwithstanding the efforts of government to create demand. There is nothing that can be prognosticated from my view, relating to any positive trends on the demand side of business. Further, if fuel prices increase markedly, demand may be further impacted.

Sprayregen: Do you expect to see more government involvement in restructurings and bankruptcies outside the financial services industry?

Carson: As we've learned in the last 12 months, the government's involvement in corporate restructuring remains somewhat unpredictable. While the government took on an unprecedented role to prevent what some perceived as systemic chaos in the financial markets, it also found itself involved in rescuing the automotive sector as well as other large companies deemed 'too big to fail'. Beyond financial services, the government set a new precedent with its unique role within the Chapter 11 filings of GM and Chrysler. In other instances, industry groups, such as the auto suppliers, have solicited government involvement to no avail. However, given the continued instability of the current economic environment and the potential for other industries to fail such as airlines and healthcare, it is reasonable to project that we have not seen the end of government involvement in the corporate restructuring marketplace.

Lonstein: I doubt there would be an upswelling of political will for further government intervention in restructurings unless new significant systemic threats emerge. We may have seen the peak with Chrysler and GM. It appears that the administration is looking to focus more on financial reforms that should be implemented to avoid a repeat of the systemic challenges we faced in 2008.

Rapisardi: This is really a policy question. Clearly the government was compelled to actively participate in the GM and Chrysler bankruptcies and played a vital role in allowing these companies to exit Chapter 11 in a timely fashion. However, it is impossible to accurately predict what role, if any, the government will play in future Chapter 11 proceedings.

The government has failed to realise that the middle market is a key component to growth. The middle market will not be assisted if tax policy or other mandates are placed upon it.

BARRY A. CHATZ

Darby: I would not expect to see the federal government repeat in other industries the unprecedented role it took in the auto industry bankruptcies. On the other hand, the sale of Chrysler and GM addressed only the front end of the automotive crisis. Many expect a shakeout among the ranks of automotive suppliers. This industry no longer is limited to the upper Midwest. Parts suppliers have spread across the country as car manufacturers have established plants in the Southeast and other areas. The auto market does not have enough capacity to support all of these firms. In picking suppliers, car manufacturers have to guess which suppliers will be chosen by their competitors and thus have enough business to survive.

Hammer: The US government recently took unprecedented roles in restructurings and bankruptcies outside of the financial services sector – notably, in the Chapter 11 cases of Chrysler and General Motors. As heavily reported in the media, the US government wore multiple hats in these cases: an insurer of trade receivables, a DIP lender and an asset purchaser. Although the final verdict on these restructurings will take years, precedent now exists to support similar government intervention in corporate restructurings across industries critical to the overall economy such as healthcare and aviation. Another interesting example of government involvement in restructurings involves the government-owned US Postal Service which continues to struggle with reduced market share and difficult operational issues.

Owsley: The CMBS issue continues to hang over sectors like a sword of Damocles – and it is not just pure financial institutions that are exposed. It is impossible to predict what the government is going to do – I'm not sure even the government knows. What we do know is that they are still active in the auto sector, and there are huge amounts of capital out there that are yet to explode, primarily in commercial real estate.

Chatz: It is not clear if the government understands that middle market businesses need the support that has also been provided to the auto companies and finance industries. The middle market is dealing with a general malaise due to lack of sales. The government has failed to realise that the middle market is a key component to growth. The middle market will not be assisted if tax policy or other mandates are placed upon it.

Mairo: In addition to the government's involvement in the financial services industry, the US government has taken a major role in restructuring the auto manufacturing industry. The government provided pre-bankruptcy and post-bankruptcy financing to both GM and Chrysler, and became partial owners of the 'new' entities through Section 363 sales blessed by the respective bankruptcy courts. Similar to what was heard during the bailouts of certain financial institutions, the government seemed to justify its financing of the auto giants by asserting that the ripple effect on the economy would be much worse if one or both of these manufacturers were liquidated. While that may have been a valid justification for the government to become heavily involved with the financial services and auto manufacturing industries, I don't expect the government to blatantly insert itself in other industries because it appears as though the US economy is beginning to stabilise and there may not be other industries which pose similar 'ripple effect' dangers. ■