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ROUNDTABLE

US BANKRUPTCY

Although the US restructuring market is still near the bottom of its cycle, industry professionals are noting economic trends and rising leverage levels as reasons to believe broad corporate distress may soon be on the rise. When bankruptcy rates do take hold, the ensuing restructuring cases will present new challenges through complex financing arrangements, heated intercreditor disputes, disastrous pension shortfalls and delicate labour negotiations. In addition, uncertainties continue to surround the full impact of the Bankruptcy Abuse & Consumer Protection Act on future engagements.

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THE PANELLISTS

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What are your broad thoughts on the state of the bankruptcy market in the US in the last year? What notable trends emerged, or persisted?

Wexler: US bankruptcy filings are, in fact, experiencing a notable decline. Chiefly, the market shows a slowing in retail bankruptcies and a marked increase in filings of manufacturing companies and suppliers to the US automotive industry. Large retailers are merging with or acquiring small competitors as traditional stores try to compete with the warehouse discounters such as Wal-Mart. Ongoing commercial aviation Chapter 11's, such as Delta and Northwest, reflect the continued hesitation of the travelling public in the wake of 9/11.

Schnelling: The bankruptcy arena in the US has continued to show signs of a slow down. Chapter 11 filings are still spotty and, except for the Southern District of New York, appear to be down throughout the country. The sectors which are active are airlines (most of which have now filed or recently emerged so new mega airline cases are less likely for the foreseeable future), automotive (Collins & Aikman, Tower Automotive and Delphi) and some financial services providers (Refco and Plus Funds). Firms which are not active in these cases are living off backlog. This situation appears to be a continuing result of the enormous liquidity available to hedge funds and other investors in distressed companies who are buying and refinancing companies which need restructuring and deferring the reckoning these companies eventually face due to structural problems in their operations or industries. However, in the past few months some evidence has emerged suggesting a general reengagement in the insolvency arena due to rising energy costs and interest rates.

Lastowski: Widespread predictions that there would be an avalanche of filings on the eve of the effective date of the Bankruptcy Abuse and Consumer Protection Act (BAPCPA) were not realised. In Wilmington and New York, the pace of filings has been slow, but steady. BAPCPA created strict, even harsh, deadlines, which encourage pre-bankruptcy planning. Broadly speaking, there has been an increase of so-called pre-arranged cases, where the debtor and major constituencies (e.g., first and second lien holders or first lien holders and bondholders) agree to a plan term sheet prior to filing.

Kremen: After the enactment of BAPCPA, bankruptcy filings initially declined (in part because of a spike in cases filed immediately prior to BAPCPA). Recently, there has been an increase in the number of business filings which probably is the result of various economic pressures (including erosion of liquidity as a result of recent interest rate increases). The filings continue to be concentrated in certain jurisdictions (i.e., Delaware, the Southern District of New York and Nevada). 'Pre-packaged' filings (i.e., where the debtor has a pre-arranged agreement with its lender and/or other major constituencies) and Chapter 11 liquidations (cases where the debtor seeks to use the Bankruptcy Court to liquidate) are still very popular.

Hammer: On the creditor side, non-traditional financiers, such as hedge funds, have become increasingly active in lending to troubled companies. These players have exercised, and will continue to exercise, considerable influence in restructuring scenarios given their rights as second lien and mezzanine lenders. On the debtor side, more companies are expressing interest in prepackaged bankruptcies in light of the recent amendments to the US Bankruptcy Code. We expect more prepackaged bankruptcies as hedge funds which are driving the process seek to convert their second lien or mezzanine debt into new equity.

Smith: The number of large bankruptcies continued to decline during 2005, by about a third compared to 2004, which was already a downturn year. But, at the beginning of 2006, the trend is towards an increase in cases over 2005, which is an interesting and perhaps surprising anomaly. The sense is that bankruptcy cases are picking up.

Benvenutti: Chapter 11 practice is and will remain heavily concentrated in New York. Great liquidity in the market (especially from private equity and hedge funds) and understandable desire to avoid expense and potential loss of control inherent in the Chapter 11 process has led to out-of-court restructurings and lenders cashing out of undesired debt at a discount (sometimes much less of a discount than would appear warranted) rather than precipitating formal proceedings. We will continue to see industries affected by high fuel costs and large pensions in financial distress. The pension issues probably require a legislative solution, which is not likely to be forthcoming any time soon. Financial distress will persist for companies with substantial fuel or petroleum costs unless the affected companies can pass the added costs along to their customers. Alternative fuel sources, while absolutely necessary, will not resolve this problem in the short term.

What sectors would you say have developed structural weaknesses over the last 12-18 months in particular? Are there any sectors that may be on the cusp of a crisis in the near future?

Kremen: Businesses in (or dependent on) the automotive, airline and manufacturing sectors continue to experience financial distress resulting from labour/pension concerns and constantly increasing fuel costs. The healthcare industry also has experienced financial distress recently. These industries will continue to incur problems in the near future. With the softening of the real estate markets and rising interest rates, we expect a growing number of bankruptcies in the real estate sector. We also expect bankruptcies in general will increase due to: first, potentially stricter standards with respect to reporting in financial statements and SEC filings, and second, the anticipated downturn in economic conditions in 2007-8.

Lastowski: The automotive industry continues to be a steady source of filings. Intense international competition and burdensome legacy costs (e.g., pension contributions, retiree medical benefits) have rendered the future of the US automobile industry uncertain. In the last year, manufacturers have increased pricing pressure on suppliers. Several Tier 1 and Tier 2 suppliers have sought Chapter 11 protection. More are on the way. At some point, increased gasoline prices may have a negative effect on consumer spending, which could have harsh repercussions on the retail sector.

Smith: The automotive sector is in relatively steep decline and consolidation. We expect that the number of Tier 1 and Tier 2 auto companies will halve over the next two or three years. Besides auto, the paper and packaging sector is in decline for two reasons. The primary reason is energy costs and the second reason is its dependence on raw materials such as petro-chemical derivatives – poly-propylene, poly-ethylene, etc. In the retail sector, particularly groceries, some large chains are under pressure from the industry leader that satisfies the needs of consumers who are generally time deprived and need to centralise more of their shopping.

Hammer: The real estate and automotive sectors are likely to experience further structural weakness over the next 12-18 months. Many economists have predicted a major slump in the US real estate market in the near term as the effect of higher interest rates take root. Banking and construction will feel pressure as foreclosure rates tick higher. Bankrupt Tier 1 automotive suppliers – such as Delphi and Tower – have placed the entire automotive supply chain at risk. We expect many more automotive suppliers to seek bankruptcy protection as a result of tightened credit in this sector over the next 12-18 months.

Schnelling: The airline industry continues to be weak and is likely to remain that way due to the continuing rise in fuel costs and pricing pressure on revenues from low cost entrants. The automotive industry has also developed serious weaknesses led by the decline in market share enjoyed by the big three American automakers (GM, Ford and Daimler Chrysler). Recent automotive supplier bankruptcies – Delphi, Tower and others – have demonstrated that the industry's cost structure is skewed against US manufacturers and distributors by factors relating to continuing globalisation. Sector margins within these global companies show a significantly higher profit margin available in overseas operations when compared to domestic US operations. Legacy labour issues revolving around high pension and healthcare costs continue to plague both industries, and higher wage rates than overseas competitors in Asia continue to have a significant adverse impact on the automobile sector. Other industries which appear to be developing weaknesses again are healthcare and retail.

Wexler: Commercial aviation has been structurally weak for at least a decade. TWA, Eastern and Pan American have disappeared after attempting reorganisation under Chapter 11. Business travel has become increasingly restricted as more companies look to cut costs. After the drastic reductions in manpower, labour costs and a worldwide consolidation of routes, gates and services, the airlines are even now facing the potential shock of a sharp increase in fuel costs. These new rules of the airline industry may still be the death knell for weaker carriers. The US automotive industry is in crisis, now, and the OEMs and its suppliers are together feeling the crunch both within the US market and many resultant effects abroad.

Benvenutti: Aside from the obvious ones – autos and auto suppliers, airlines (though not many of those left to file, unless as Chapter 22s or 33s) – I would not be surprised to see significant problems develop in the housing/construction industry and related suppliers, if the housing market cools. I think consumer confidence is a lot shakier than the indices indicate, as middle and working class consumers are being squeezed on numerous sides by rising energy and healthcare costs, general inflation, rising interest rates, loss of good-paying manufacturing jobs (or contraction in benefits from those jobs), and loss of the opportunity to withdraw value from homes. If this translates to a significant contraction in consumer spending, many industries – both US and international – will experience significant revenue losses.

What do you anticipate will be the most significant impact of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) on business bankruptcies?

Lastowski: BAPCPA has created strict deadlines. For example, a debtor's exclusive right to file its own plan (and thus control its destiny) is limited to 18 months. A debtor must determine whether to assume or reject commercial leases within 210 days. Further, trade creditors now have expanded rights in Chapter 11. These factors increase the pressure on a debtor to achieve consensus quickly in order to emerge from chapter 11. As a result, there will be an increased number of pre-packaged or pre-arranged plans, in those cases where a debtor's constituents believe that they can maximise recovery through reorganisation. It is unclear whether companies burdened by asbestos liabilities, which have traditionally taken years to reorganise, will be able to achieve reorganisation within the new deadlines.

Consumer confidence is a lot shakier than the indices indicate. If this translates to a significant contraction in consumer spending, many industries – both US and international – will experience significant revenue losses.

PETER J. BENVENUTTI

Schnelling: Timing is likely to have the greatest impact on business bankruptcies. The major changes in BAPCPA shorten the time in which companies can act to restructure themselves in a Chapter 11. Significant issues here revolve around the new requirement that companies address their intentions on leased real property within the first few months after filing and be prepared to file and confirm plans of reorganisation in a significantly shorter time frame than in the past. For companies which require significant time to organise and negotiate among their many disparate constituencies – like United Air Lines – it is still too early to see how effective reorganisations will occur under the new Act.

Smith: Due to the shortness of the new cycle in the Bankruptcy Act, we will see more 363 sales – the sale of a company unencumbered by its liabilities. We will also see more pre-packs – cases that are pre-negotiated with respect to the treatment of the different tranches of debt, such as a debt for equity swap. Because of the time constraints, companies will be in bankruptcy for a shorter period of time and it will be important to have the creditors agree quickly. The reorganisation of companies is in decline, while the sale of companies to strategic or financial buyers is on the increase.

Kremen: BAPCPA has eroded many of the debtor's traditional procedural advantages. For example, it has substantially reduced the time limits during which a debtor has the exclusive right to file, and solicit acceptances for, its plan of reorganisation and to decide whether to assume or reject its executory contracts and unexpired leases. It also has changed the practice with regard to how to provide adequate protection to utilities and handle reclamation claims. Debtors must now pursue substantial additional pre-filing planning if they want to enhance their prospects of reorganising. ▸▸

Hammer: While my colleagues have touched on the many pro-creditor aspects of BAPCPA, this legislation stands to significantly impact cross-border business insolvencies with the incorporation of the UNCITRAL Model Law on cross-border insolvencies into the new chapter 15 of the US Bankruptcy Code. The Model Law, which has been adopted in a number of foreign jurisdictions, including most recently in the UK, provides for a recognition proceeding in the US of a foreign insolvency proceeding. We expect further harmonisation of cross-border insolvency proceedings among multiple jurisdictions with the adoption of the Model Law in the United States.

Wexler: This is a 'pro-creditor' law with the goal of eliminating the frustrating delays of the 1978 Code. A debtor now has new firm and fixed deadlines for making decisions and performing in Chapter 11. From rejecting commercial leases to filing the plan of reorganisation, all timelines have been moved up with little room for getting extensions of dates. It's too early to tell, but we should see more cases moving towards successful reorganisation or early liquidation, efficiently and expeditiously.

Benvenutti: There will be even more concentration of larger Chapter 11 cases in New York (and to lesser extent, Delaware) based on the perception that those courts are more debtor friendly and offer greater flexibility in dealing with the anti-management and anti-debtor provisions of BAPCPA.

What new issues do you believe BAPCPA has created for business bankruptcies?

Smith: The cost associated with a bankruptcy filing will be more front-loaded. For instance, under the new code revisions, utilities – telephone, heat, electric, and the like – are entitled to adequate protection payments generally equal to two months of the debtor's burn rate, which basically means the company will have to put up new deposits post petition. Also, reclamation claims – claims for products that were delivered in the weeks before the filing – now have to be settled in cash earlier, whereas previously there would be an administrator claim that could be settled at the end of the case. The changes to the code have forced a need for debtors to draw down more cash on the debtor-in-possession financing earlier in the case. This creates bigger debts sooner and makes stakeholders even more uncomfortable.

Kremen: BAPCPA presents a number of new challenges for debtors. Expanded grounds for conversion or dismissal of business cases will put marginal debtors in jeopardy. Similarly, new reporting requirements imposed in small business cases may lead to more conversions and dismissals absent appropriate pre-bankruptcy planning. Where creditors' committees are active, there are new requirements to provide information to all constituents, which pose confidentiality issues. Although appointed so far in only a handful of cases, the appointment of a patient care ombudsman in healthcare cases could significantly increase administrative costs.

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WILLIAM A. WEXLER

Wexler: 11 USC Section 308 imposes new reporting requirements on small businesses, including disclosure of cash flows, profitability and comparison of budget to actual performance. 11 USC Section 365(d)(4) shortens the deadline for assuming or rejecting a commercial lease to 120 days after the case is filed or the date the debtor's plan of reorganisation is confirmed, whichever is earlier. 11 USC Section 503(b) & (c) sets a ceiling on key employee retention plans (KERP) at 10 times the 'mean' of similar payments to non-management employees. 11 USC Section 546(c) gives the unpaid vendor 45 days pre-petition on reclamation claims instead of 10.

Benvenutti: One very significant change in business bankruptcies – and the reason many corporations raced to the court before BAPCPA became effective – were Section 503's limitations on the ability to provide retention packages to attract or retain top management. Though this may have been a noble attempt to reduce the tremendous disparity between labour (often unionised labour) and senior managers, creative approaches to circumvent the Congressional intent are already appearing – whether through consulting agreements or other contracts, agreements or benefits that avoid the constraints of BAPCPA. The result may be less disclosure or transparency for creditors as to the benefits being received by senior managers. Additionally, though BAPCPA attempted to provide more disclosure to general creditors with the inclusion of Section 1102(b)(3) requiring Unsecured Creditors Committees to provide general creditors with information regarding the bankruptcy, confidentiality orders are likely to dilute significantly the extent of meaningful information actually made available to general creditors.

Lastowski: For businesses contemplating Chapter 11 relief, BAPCPA creates a host of new issues. For example, for a national retail debtor which seeks to reorganise around a core group of profitable locations, the decision whether to assume or reject a marginal location will have to be addressed and resolved very early in the reorganisation process. The amount of financing necessary to fund the reorganisation may also increase due to the augmented rights of utilities and trade creditors under BAPCPA. A debtor's initial debtor in possession budget must now include payments to utilities and certain trade creditors, whose rights are expanded under BAPCPA.

Schnelling: The primary issue is a general shortening of the time available to companies looking to restructure. Several more specific issues also come immediately to mind. BAPCPA has heightened the focus on addressing real estate issues and shifted power from the lessee to the lessor in the discussion on how to treat assets in this category. This shift in power and focus is also likely to increase the pressure on lenders to think more carefully about loans which require liens on real property assets to give the lender adequate collateral. As a result of BAPCPA changes, the collateral may be stripped from the debtor by the landlord during the bankruptcy. Providing retention payments that are perceived as adequate to senior managers has become significantly more difficult under BAPCPA because of the new rules requiring more equity in the gap between senior payment plans and rank and file payment plans. New rules on reclamation and a shortening of the period in which pre-petition payments by a debtor are considered preferential increase the financial strain on debtors by shifting significant amounts of debt from the pre-petition unsecured category to the post-petition administrative category.

Hammer: BAPCPA places significant restrictions on a debtor's ability to pay retention bonuses to management and other 'key' employees during the bankruptcy case. Under the old law, debtors routinely obtained court approval for lucrative key employee retention plans. KERPs had been criticised for taking money out of creditors pockets, but the new law substantially curtails the amount of bankruptcy bonuses for executives, who must further provide evidence of 'bona fide' job offers from another business at the same or greater rate of compensation, to earn any bonus. Payments to non-executives must now be 'justified by the facts and circumstances of the case', so expect increasing litigation before bankruptcy courts over KERP approval standards.

Do you anticipate that the law regarding deepening insolvency will become more settled? If so, how will the debate over liability for deepening insolvency be resolved? If not, what issues do you anticipate coming to the forefront of the debate?

Hammer: The law of deepening insolvency is largely unsettled in the United States. While courts should establish a more cohesive set of precedent respecting deepening insolvency claims over the next several years, it is possible that a split among the various judicial circuits may occur. As such, it may take some time before courts reach a broad consensus on the viability of deepening insolvency as a legal theory. In the meantime, trade creditors seeking to prove their damages against senior lenders in these cases will face hurdles, especially where breach of fiduciary duty claims exist against officers and directors.

Benvenutti: I hope it becomes more settled by the recognition that deepening insolvency is not a separate legal theory, but rather a possible damage theory if the plaintiff (whether trustee/estate representative on derivative claim, or creditors on legally cognizable direct claim) can establish a traditional basis for liability on the part of corporate officers and directors, as well as causation. As of now, the law is very muddled. Some clear and well reasoned case law at the appellate level would be welcome.

Lastowski: The law of deepening insolvency will become more settled as an increasing number of courts will refuse to recognise the tort and restrict its use to a measurement of damages. It is settled law that a corporations' officers and directors owe a fiduciary duty to creditors once the corporation enters the 'zone of insolvency'. The tort of deepening insolvency merely recognises that these individuals may be responsible for harm to trade creditors arising from operating the corporation as it slides further into the red. Most courts hold that this 'tort' does not exist independently of a cause of action for breach of fiduciary duty or fraud. This analysis will gain increasing acceptance.

Kremen: The law on 'deepening insolvency' remains in flux and it appears that no consensus is in sight. Whether it should be construed to be, one, a separate, cognizable cause of action, two, a methodology for quantifying damages, or three, a factor at all, in the short term, will continue to dominate this debate. In our view, the concept will be ultimately vetted on a jurisdiction by jurisdiction basis with an emphasis on applicable state law.

The law of deepening insolvency will become more settled as an increasing number of courts will refuse to recognise the tort and restrict its use to a measurement of damages.

MICHAEL R. LASTOWSKI

Schnelling: The answer to this question depends largely on whether the issue rises to a level where the Supreme Court gets and accepts certiorari on a case which forces it to confront and decide the issue directly. Until that happens, the circuits are likely to remain widely apart on whether such a cause of action exists at all. In the meantime, in circuits where the doctrine gains acceptance its application is likely to be applied on a fact specific basis which will allow individual bankruptcy and district courts to carve out positions based on factual interpretations which may be inconsistent with their circuit's views on the legal doctrine.

Wexler: Ideally, this should be solved by legislation. However, for now it looks like US judges will debate this concept in published opinions until some case works its way to the US Supreme Court for final resolution. State and Federal Courts are seeing more of these cases, with court decisions differing over recognising deepening insolvency as a legal claim. The unresolved issues may include: one, is deepening insolvency a legal claim?; two, if there is liability, how deep into the business does it reach? Are all officers and directors liable? What about outside auditors and/or consultants; three, is insurance coverage available?; and four, how do we measure damages?

Has an increase in exposure to potential liabilities, such as negligence and malpractice claims, changed the way today's turnaround and bankruptcy professionals approach new instructions?

Lastowski: Years ago, in the Merry-Go-Round case, a Chapter 7 trustee sued a debtor's adviser, contending that the adviser was responsible for the debtor's failure to reorganise. The trustee received a substantial settlement. Since then, estate professionals have been on heightened alert for potential exposure. Pre-filing, prudent professionals confirm the existence of adequate D&O insurance. Post-filing, court-approved retentions should include the broadest permissible indemnity provisions. In Delaware, after the United Artists decision, financial advisers are able to negotiate strong indemnity provisions which give them the benefit of the so-called business judgement rule. These two precautions, coupled with the fact that, in Chapter 11, material business decisions are court-sanctioned, provide as much comfort as can be secured in a bankruptcy case.

Kremen: A number of high visibility adverse decisions and the potential implications of Rule 9011 have made bankruptcy professionals more cautious. Indeed, many professionals will not even accept an engagement absent strong indemnification and exculpation protections. This trend may be slowed somewhat by the enactment of amended 28 U.S.C. §1334(e), which requires claims involving professional negligence and breach of fiduciary duty claims under 11 U.S.C. §327 (at least those arising pre-confirmation) to be heard in federal court. Even with this added layer of protection, however, bankruptcy professionals are still being much more selective in their acceptance of new engagements.

Schnelling: The likelihood is that the debate in cases which are before the courts will continue to focus on professionals trying to assure their engagements are covered by indemnification – presumably for any acts which do not constitute gross negligence or wilful misconduct. In cases where the engagement is out of court, professionals will also try to limit damages to the amount of fees earned in the engagement in order to protect their firms and practices. Unfortunately, increased vigilance about quality control on the part of professionals is not likely to diminish the number of negligence and malpractice suits brought against them. Now that professionals and their errors and omissions policies are viewed as deep pockets for creditors to consider as sources for recovery there will not be, in all likelihood, much diminution of such claims – valid or invented.

Wexler: Insolvency professionals must be able to give an analysis of the full range and amount of claims against the company and advice on how to successfully restructure a distressed company. Said professionals must be alert to changes and trends in negligence and malpractice because these claims are now part of the financial obligations to be restructured and resolved. For example, does a retiree or employee, who is also a shareholder, have a malpractice claim against the company's independent auditors or legal counsel for bad advice that resulted in the unnecessary reduction or termination of pension benefits? A distressed company may have reduced or terminated pension benefits before filing Chapter 11, based on bad advice. We shall see if the beneficiaries have a claim against the independent auditors or counsel and if the company can or will indemnify its CPAs and lawyers.

Even with this added layer of protection bankruptcy professionals are still being much more selective in their acceptance of new engagements.

RICHARD M. KREMEN

Benvenutti: I don't think it's fundamentally changed the way professionals handle their engagements. Indemnification agreements seem to be uniformly rejected by the courts – even in NY – except for investment bankers/financial advisers in some situations. However, the increased litigiousness of creditor groups – especially committees of bondholders or holders of claims purchased by vulture funds – tends to drive up the cost of the Chapter 11 process as both professionals and management spend more resources on self preservation, ironically for the benefit of constituencies that bought into the distress situation at a (usually very large) discount. I don't see this trend changing, either through legislation or judicial oversight.

Hammer: Professional liability issues are always on the minds of turnaround and bankruptcy professionals. However, I can speak for myself and the overwhelming majority of my colleagues in the US restructuring community in stating that regardless of the current litigation environment as it relates to professional liability, the community at large exercises the utmost due care in performing their engagements. Any increase in professional liability awards should further ensure that each and every professional in our community exercises due care in every single engagement. Given that restructuring professionals are often viewed as 'deep pockets' by cash hungry trustees, however, the spectre of professional liability may permeate each engagement and should be taken very seriously.

How can pension issues derail the restructuring process? In your experience, what steps should be taken to mitigate or overcome this systemic problem?

Schnelling: Pensions are an obvious problem when the annual expense of maintaining health and pension plans rise to a level which constitutes a significant percentage of a debtor's annual revenue. The difficulty is that the expense is a present or deferred cash cost to the debtor and, if deferred, can rise to levels which become completely insurmountable for a debtor struggling to reorganise. Whether or not these issues derail the process for any debtor is directly dependent on the size and immutability of the annual payment any debtor's pension and benefit plan requires. The simplest prophylactic is to avoid instituting plans going forward which require annual payments of defined amounts in lieu of profit based pension plans and contributory medical benefit plans. Unfortunately, for companies with large 'legacy' pension and benefit issues there is no real solution except use of applicable rules and statutes to try to shift the burden from the debtor, generally to government entities like the Pension Benefit Guaranty Corporation (PBGC) in the United States. In cases where these obligations cannot be eliminated, debtors are likely to fail and have to liquidate.

Smith: This is a big issue in the US, cutting across several cases at the moment. Since people are living longer, working longer and earning more money, the cost of defined benefit plans has escalated exponentially, creating a big problem for both organised labour as well as for the PBGC. Since the PBGC is like an insurance agency for the pension plans, it has become an increasingly active creditor. Some cases involve secured banks, trade creditors and the PBGC – each with disparate issues. The banks want to preserve as much of their secured debt as possible, and are really not interested in obtaining equity in the company. Trade creditors want the company to emerge from bankruptcy so they can put products into the distribution channel and make money. And the PBGC wants the company to emerge as liquid as possible so it can honour its pensions. With such a disparate class of creditors all thrown in together, it makes for a difficult representation for a financial adviser who needs to manage the various objectives.

Lastowski: For so-called legacy companies, large, unfunded pension obligations can be crippling. Post-petition pension obligations may be entitled to administrative claim status and can lead to administrative insolvency, a prelude to a forced Chapter 7 liquidation. Chapter 11 is a consensus building process, and a debtor is well-advised to address pension issues by extending an olive branch. In the context of under-funded pensions, a debtor must either make peace with the PBGC, as in the United Airlines case, or with its union, as in the Delta case.

Kremen: As underfunding (the shortfall between the value of benefits and assets) in single-employer defined benefit plans (an estimated $450bn in 2004) has continued to increase, so also has the incentive to terminate these plans. On termination, the PBGC will take over the plan, with the debtor and each of the members of its control group (including non–US members), becoming jointly and severally liable to the PBGC for, among other things, any underfunding. Often times, the PBGC emerges as the debtor's (and its control group members') largest and most aggressive unsecured creditor (because of PBGC's increasing deficits – $23.3bn in 2004). It may have a seat on the creditors' committee. It may also have a significantly different agenda than other constituencies. Spurred by airline, steel and auto-parts bankruptcies and increasing PBGC deficits, Congress is considering legislation which would require employers to increase funding both to their plans and to the PBGC. Meanwhile, employers, asserting that they can no longer afford defined benefit plans, are replacing them with defined contribution plans – especially 401(k) plans – which require the contribution of prescribed amounts to individual accounts and which shift investment risk from the employers to their employees.

Hammer: Pensions issues have great potential to derail a restructuring in the current economic environment and may cause an otherwise economically viable business to cease operations entirely or to abandon their restructuring in favour of an asset sale. We have seen this potential nearly play out in several of the recent airline and automotive bankruptcies such as United Airlines and Delphi. The legacy pension programs of many manufacturers, most notably General Motors, may bring such companies to their knees. Multi-employer pension plans present another layer of significant issues in corporate restructurings. A comprehensive legislative approach appears necessary to address the significant economic and legal issues presented by pensions in corporate restructurings.

Wexler: Pension liabilities can sink a restructuring. Yet, 11 USC Section 1114(l) gives the Court authority to reinstate pre-petition reductions in pension plans. Open and honest negotiations with pension trustees, with an eye fixed on reality, may be the only way to get voluntary adjustments. Failing a compromise, changes are fought out in often long and expensive court battles, with the outcome uncertain.

What effect are labour negotiations having on some of the high profile bankruptcies of the moment? What path to resolution do you believe is the most effective when dealing with workforces?

Since people are living longer, working longer and earning more money, the cost of defined benefit plans has escalated exponentially, creating a big problem for both organised labour as well as for the PBGC.

SHEILA T. SMITH

Hammer: Delphi's bankruptcy aptly illustrates how labour negotiations can impact the restructuring process. Delphi has been negotiating with the United Auto Workers, among other unions, in an effort to slash hourly wages and benefits, but no solution appears in sight given the scope and complexity of the issues. Effective labour negotiation tactics are far too complex to discuss here, but among other things, management should employ a strategy of transparency, honesty, and pragmatism when dealing with its employee constituencies.

Smith: A look at the steel industry, which was heavily unionised and very capital intensive, shows labour cost issues as well. Steel could be made cheaply elsewhere. US plants were antiquated. The equipment was old. Companies were not reinvesting in the infrastructure. Labour was expensive. The automotive industry is suffering from similar problems, and labour is right in the middle, so it will be interesting to watch what happens in Delphi.

Lastowski: In the Chapter 11 case of auto supplier Delphi, the company has sought to terminate its collective bargaining agreement with the United Auto Workers (UAW), among other unions. The UAW has authorised a strike against Delphi. Although this is not unexpected, and will be part of the bargaining process between labour and management in the Delphi case, an actual strike might have a fairly quick and direct impact on General Motors, Delphi's former parent and largest customer. From there, the dominoes will begin to topple. Post-filing negotiations with unions are difficult. Often, the union has made concessions pre-filing, based upon management's contentions that these concessions will avert a filing. The level of trust deteriorates in a chapter proceeding, where lenders and creditors' committees seek to influence management. A strong degree of transparency is critical to building consensus.

Wexler: The US Bankruptcy Code, 11 USC Section 1113 calls for a full exchange of information and good faith negotiation before a collective bargaining agreement can be rejected. Delphi is presently in Court on a motion to reject its United Automobile Workers (UAW) agreement. The UAW has authorised a strike if Delphi management is successful in rejecting the union contract. As of this date, the presiding judge continues to encourage all parties to reach a consensual agreement. If there is ultimately to be no agreement, then the judge will decide the motion. If such a prospective decision is to allow rejection of the UAW agreement, then the UAW is likely to strike. Such an action will severely – and negatively – impact major sectors of US automobile production. What can be done? All parties must reach a negotiated settlement to avoid this nightmare scenario. No party should appear to force another's back to the wall, either pre- or post-petition. It only makes the process more expensive and uncertain.

Kremen: A number of debtors in recent airline, steel and auto parts bankruptcies have tried to use pre-filing collective bargaining and the threat of post-filing Chapter 11 processes (11 U.S.C. §§1113-1114) to obtain relief from 'legacy' liabilities (health, pension, etc.) and wage/operational restrictions. They have cited collective bargaining agreements (CBAs) as one of the primary causes of their deteriorating financial performance. Where pre-petition negotiations with unions have failed to result in sufficient concessions, Chapter 11 cases have been commenced, with the debtors, at the outset, requesting that the court set hearings on CBA rejection and/or elimination of retiree benefits. Arguing that consensual resolution is preferable to court imposed relief, debtors have sought 'authority' to reject CBAs and/or eliminate retiree benefits (rather than court ordered rejection/elimination) in the event renewed negotiations were unsuccessful. For a variety of reasons (including, *inter alia*, decline in union influence, few employee options for union members, and the debtor's desire/willingness to sell/otherwise rid themselves of certain domestic operations), a 'divide and conquer' strategy in working with unions can be successful. Unions can find themselves characterised as the last 'impediment' to reorganisation and can be placed strategically in a vulnerable position by the end of a Chapter 11 proceeding.

Schnelling: Because of the relative size of the dollars involved, labour negotiations are the primary driver in many current high profile bankruptcies (airlines and automotive suppliers) and are driving many currently 'solvent' companies into bankruptcy in order to resolve their uncontrollable labour and benefit costs. There is no 'effective' way to deal with these issues. Where the workforce is forced to relinquish existing rights and accept lower expected pension benefits it has an adverse effect on the overall economy because it changes spending expectations for people who thought their retirement was, but know it no longer is, secure. Honest dealing with workforces and firmness in setting out the economic requirements for eliminating these expenses is the only way to proceed. However, nothing can deflect the anger and suspicion created by a debtor's inability to honour its promises to its workforce.

Among other things, management should employ a strategy of transparency, honesty, and pragmatism when dealing with its employee constituencies.

AARON L. HAMMER

To what extent will prevailing private equity leverage levels provide work for bankruptcy professionals in coming months, or years? Have these financial and operational experts taken on more risk than they realise?

Benvenutti: The currently available oceans of liquidity provide a low-maintenance exit path for hedge funds holding distressed debt – they sell at a discount to another hedge fund that trades in lower-rated debt and go on to the next deal. This doesn't produce much work for bankruptcy professionals, except for the funds that focus on distressed businesses, and whose business model is to restructure the debt, including through Chapter 11, rather than to sell to another fund lower on the food chain. But if there is a significant contraction in the appetite for distressed debt, and the preferred exit path is closed off, there will be a lot of additional work for bankruptcy professionals, both in restructuring portfolio debt, and for many funds themselves that find themselves over leveraged or with significant mismatches between assets and commitments.

Wexler: It can be readily acknowledged that there continues to be far more private equity investment dollars chasing fewer 'doable' deals. Certain trends are seen as a result. First, leverage levels are undeniably increasing. Heated bidding contests tend to develop more aggressive valuations which in turn are often supported by an increasing number of competitive lenders seeking new loan inventory at a time when their historic non-performing loans have substantially diminished in the past several years. Secondly, private equity firms in recognition of the first development have increased 'club investments' where now it is more common to see two – or more – brand name private equity firms partner with one another to bid on larger and sometimes more high-risk projects. Third, we are seeing a significant increase in the demand for due diligence services – either acquisition or disposition – which suggests that the private equity community is largely taking more conservative and prudent steps to guard against future trouble.

Kremen: With debt to income ratios (total debt to EBITDA) often exceeding 5 to 1 in private equity transactions, borrowers have been left with precious little cushion to absorb, one, borrower- or industry-specific problems, two, a continued rise in global interest rates, or three, a general economic slowdown. The current economic warning signs, coupled with global geopolitical instability, lead us to conclude that many private equity-financed borrowers will be forced to restructure through the use or threat of the bankruptcy process. As a result, within the next 12 months, bankruptcy professionals should experience a significant increase in transactions.

Schnelling: To the extent that private equity or hedge funds provide capital in deals which compromise the returns they need to provide for their investors, they are lowering the quality of their investment and raising the level of results their portfolio investments need to produce to be profitable. As interest rates rise and structural problems like globalisation continue to be present, the likelihood is that there will be an increase in work for the bankruptcy and turnaround community. The timing of such a result remains elusive but will be affected by energy cost levels, interest rates and continuing movement of US jobs offshore. Anytime a sponsor lowers its target levels on returns to accommodate its need to invest its capital it has taken on increased risk. It seems unlikely that sponsors don't realise that their risk profile may be rising. What is more likely is that they just may not be able to avoid the increase in risk if they are to stay in business.

Lastowski: For several years, too much money has been chasing bad loans. As a result, financially distressed companies have had little difficulty finding new sources of capital to avoid bankruptcy. Every year, pundits predict the collapse of the house of cards. Every year, however, the flow of capital continues, albeit in the context of financings which are fairly onerous to the borrower. Any number of factors, including rising interest rates and fuel costs, could severely diminish this flow of capital and lead to increased filings. However, a highly-leveraged corporation, which has pledged all of its assets, has little room to manoeuvre in a bankruptcy. A Chapter 11 liquidation which fails to yield proceeds to satisfy the secured debt will be the ultimate proof of undue risk.

Smith: Many work out people are hoping that hedge funds, private equity groups and venture capital funds will provide an abundance of work in the future. Work is already starting to come through from the distressed portfolios within larger funds, as they seek to carve out, refinance or liquidate underperforming companies at the bottom of the portfolio in order to concentrate on the high ticket deals.

Hammer: Private equity shops have become top client prospects for restructuring professionals who forecast a perfect storm gathering in the market: high valuation multiples, together with rising commodity prices and higher interest rates. Experienced turnaround professionals will be required to assist private equity funds resolve their portfolio companies' capital structure problems presented by over-leverage and non-traditional debt and equity financing such as second lien debt and preferred stock.

Will the evolving capital structures of public and private-equity backed corporations create serious problems for advisers engaged to restructure them?

Kremen: The proliferation of second lien debt, and the more complicated lender-group dynamics that often accompany it, should certainly make the restructuring process more challenging. The existence of a second class of secured debt that from time to time may be fully secured, partially secured or hopelessly under water, including hedge funds or first lien lenders holding non-vertical strips, will create plenty of potential conflicts and competing interests for restructuring advisers to navigate.

Lastowski: Given the complexity of current capital structures, consensus will be difficult to achieve outside of bankruptcy. Today's capital structures may often include two separate layers of secured debt, combined with subordinated debt or debt-equity instruments (hybrid securities). Achieving consensus will be difficult with so many players at the table. Valuation issues will engender disputes between first and second tier lenders. Those holding debt equity instruments will have little leverage at the bargaining table in light of the possibility that a court may characterise them as equity holders, with diminished rights in a Chapter 11. In bankruptcy, the secured lenders will determine the fate of the debtor and its unsecured creditors, with the estate's financial advisers having little room to manoeuvre.

Schnelling: To the extent that investors are present simultaneously in multiple levels of a debtor's capital structure, any tendency by investors to protect all levels of investor capital must stress such investor's ability to avoid conflicts of interest. The tension created by investments at multiple levels must create tensions for advisers trying to maximise value for all creditors and still pay due deference to holders of the debtor's most significant stakes.

> **As interest rates rise and structural problems like globalisation continue to be present, the likelihood is that there will be an increase in work for the bankruptcy and turnaround community.**
>
> ANTHONY H.N. SCHNELLING

Hammer: Restructuring professionals are increasingly aware of the challenges presented by non-traditional capital structures and the varying perspectives of investors holding securities in these situations. In the end, however, even the most difficult of situations should resolve itself as sophisticated financial players find solutions that are driven by rational economic behaviour and fair market valuations.

In particular, are there any early indications that the resolution of intercreditor agreements between first and second lien debt holders will add a thorny dimension to the restructuring process?

Schnelling: Resolution of such agreements may well disenfranchise unsecured creditors when a debtor's resources are insufficient to cover both the senior lien holder's debt and second lien debt which springs into a first lien position upon settlement of the senior position. Second lien holders are likely to become the preferred new recipient of equity in reorganising debtors and cause unsecured creditors, who to date have been the residual owners of debtor equity, to get little or nothing out of the restructuring. The reaction of unsecured creditors is likely to increase pressure on advisers as they deal with unsecured creditor attempts to create problems and get nuisance distributions to give up their opposition to a restructuring.

Hammer: The evolution of second lien term loans and bonds as a financing mechanism will present challenges to restructuring professionals in the years ahead. Second lien financing arrangements, which provide for attractive interest rates and an expansion of borrowing options for cash-strapped companies, have skyrocketed in popularity in this decade, and many restructuring professionals have yet to counsel financially distressed businesses or their lenders with respect to such arrangements. A few thorny intercreditor issues in these arrangements include: the rights of second lien lenders under cash collateral arrangements, and when 'special' counsel is required for second lien lenders that also hold significant first lien paper.

Kremen: While there has been much speculation about possible challenges by second lien lenders to the enforceability of certain of their pre-petition waivers, most disputes in this area to date have been resolved through negotiation. We believe second lien lenders (or the subsequent buyers of second lien paper) in the future will attempt to reclaim some of these rights in contentious bankruptcy battles. This should create some interesting outcomes in the next wave of workouts, restructurings and bankruptcies. There will be difficult issues not only relating to the enforceability of subordination provisions but also adequate protection, valuation, and voting.

Lastowski: During the first half of 2006, we have witnessed cases where the tension between the first and second lien holders has been evident. Both lenders will seek recovery from the same collateral, and the second lien holders are often only partially secured. This sets the scene for post-filing battles over adequate protection payments and payments of default interest rates to the first lien holder. This impacts first and second lien holder strategies in the case, and creates the potential for conflicts of interest if both tiers of debt are represented by the same agent. The most significant litigation, however, arises in the context of valuation disputes between the second lien holders and creditors' committees. Usually, trade creditors will only see a recovery at the expense of the second lender.

Wexler: We represented a major US manufacturer where, ultimately, a Chapter 11 filing was determined to be necessary. Immediately upon filing, it became apparent that we – the debtor and its advisers – were going to be unable to settle differences between the first and second lien holders. The second lien holders litigated – and won – leaving the debtor without a debtor-in-possession loan facility resulting in a sudden conversion from Chapter 11 to a Chapter 7 Trustee. It is important to recognise the change in 2006 – private equity firms and hedge funds have become the principal financial engines servicing our economy – and their styles and strategies will need to be carefully evaluated to ensure a smooth approach to any future restructuring.

Smith: Intercreditor agreements in the US are probably not that well articulated. Legal battles will be fought over intercreditor issue of who gets what and whose collateral comes next. Considering the highly leveraged balanced sheets of many companies, there is likely to be a downturn in the value of the collateral compared to the time the capital was raised.

What part are the new debt sources likely to play in complex workouts over the next few years?

Wexler: There has been a fundamental shift in 2006 where the new and more aggressive debt sources – hedge funds and private equity – are playing a uniquely different role in the marketplace than the more traditional commercial bank lenders of only a few years back. Today's lenders are often willing to play/invest at any level of a proposed transaction. Their loyalty to a specific credit or to a management team is noticeably shorter in duration. Today's lenders are not afraid to contest, to litigate and, ultimately, to take over a company where, in the past, lenders were generally more deferential and driven by a perspective which was to work out trouble short of taking the ultimate step towards seizing ownership of a specific asset. Today's new debt sources are, in fact, changing fundamental strategies which influence companies who now are considering any or all forms of restructuring – either in or outside of court.

Kremen: Large hedge funds, specialty funds (e.g., subordinated mezzanine debt lenders) and other non-bank sources of financing have provided tremendous amounts of new liquidity, primarily in the second and first-lien markets. As default rates begin to rise or recoveries fall short of expectations, it will be interesting to notice which of these financing sources will continue to provide new liquidity and which will sell their paper to vulture funds or other buyers of distressed paper. Borrowers need to be aware that these subsequent purchasers of paper may have a significantly different agenda than traditional lenders and oftentimes are in the 'loan to own' business.

Lastowski: For the foreseeable future, hedge funds will continue to provide sources of capital in the context of reorganisations or workouts. The attraction of high returns and the need to maintain deal flow will maintain their appetite for investing in distressed companies. From the perspective of supply and demand, the balance continues to lean towards borrowers, who will continue to find hedge funds willing to make risky investments. Of course, in this context, companies will continue to become increasingly over-leveraged and will find their options limited in the context of workouts and chapter 11 reorganisation.

Smith: The US has a concept called the absolute priority rule, which basically determines who eats first before the next class of creditors can be satisfied. As a oversimplification, the senior secured takes the top position, followed by junior secured or partially secured debt, such as mezzanine strips and second lien instruments whose collateral may be under fire. Then you have the general unsecureds, which could be bondholders and trade creditors. Each class will be treated differently based on their objectives and their ability to compromise. In my view, the area where we are likely to see the most compromise will not be among the senior secured debt or trade creditors, but all the debt sources in between – the bond holders, the mezzanine players and the second lien holders – because that money is already out of the gate and that debt provider is in a compromising position.

Benvenutti: New debt sources such as private equity and hedge funds (often referred to interchangeably) are increasingly exerting more influence in the restructuring process, from purchasing claims in the bankruptcy case and supplanting existing creditors (even creditors on committees) to providing exit financing by backstopping the issuance of shares in the reorganised entity, often with the aim of gaining control of the reorganised entity. In the future, we expect to see these entities as a common source of DIP financing to replace higher cost lending sources. Typically, pre-petition lenders enjoyed a certain level of exclusivity when it came to providing DIP financing. Traditional lenders were loathe to displace other traditional lenders holding the outstanding secured debt. The order of the day was a 'roll up' of pre-petition debt with high cost post-petition financing, such that existing lenders were 'priming' their own debt. Aggressive new sources of funding will likely turn the old model on its head.

Hammer: New debt sources (particularly, hedge and private equity funds) stand to play a significant role in complex out-of-court and in-court restructurings over the next few years. Non-traditional financing sources have become increasingly more accepted and sought-after in recent years, due to historically low interest rates, an unprecedented availability of cash and the willingness of these new sources to make 'riskier' investments in exchange for prospects of greater return. The differing investment perspectives of these investors will drive much of the conflicts in future workouts. ■


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