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SPRING 2018

OPTIMIZE

VALUE FROM DISTRESSED ASSETS

A CHANGING FORECAST

Insights from Duane Morris' Business Reorganization and Financial Restructuring Practice Group Conference with TD Bank, N.A. and other industry insiders

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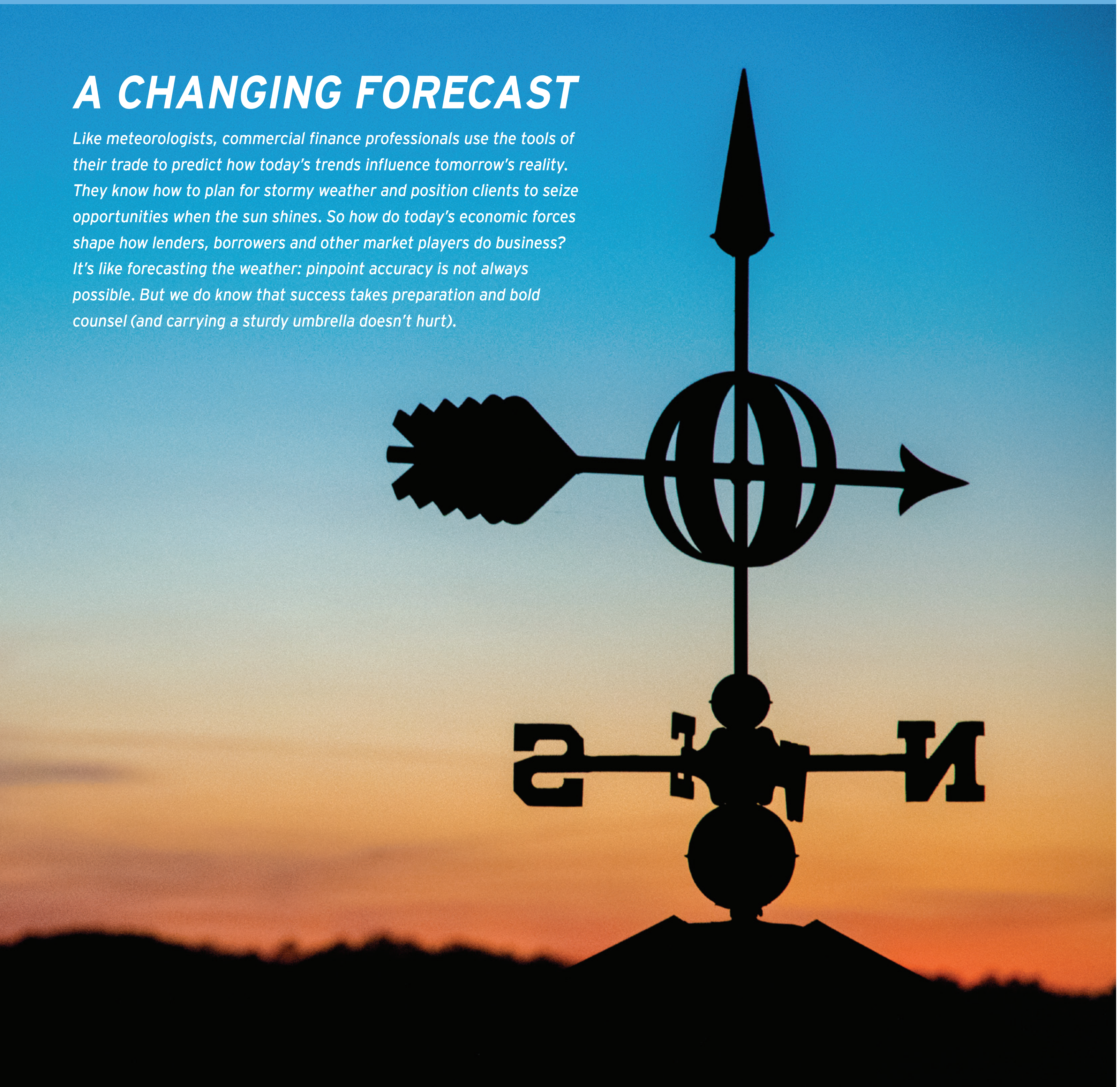

A CHANGING FORECAST

Like meteorologists, commercial finance professionals use the tools of their trade to predict how today's trends influence tomorrow's reality. They know how to plan for stormy weather and position clients to seize opportunities when the sun shines. So how do today's economic forces shape how lenders, borrowers and other market players do business? It's like forecasting the weather: pinpoint accuracy is not always possible. But we do know that success takes preparation and bold counsel (and carrying a sturdy umbrella doesn't hurt).

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LETTER FROM THE EDITORS

Bringing clients and leaders from the financial industry together to share insight on the state of commercial finance has been an annual tradition at Duane Morris for more than three decades. Our most recent Business Reorganization and Financial Restructuring Practice Group conference included a panel discussion on the dynamics of the current state of bankruptcy and restructuring. This seventh edition of our *Optimize* series takes a closer look at how the trends of the past year gauge the way forward.

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From left: Skip Di Massa, chair of Duane Morris' Business Reorganization and Financial Restructuring Practice Group, addresses Duane Morris partners Lawrence Kotler and Mairi Luce, Ankura's Bob Frezza and TD Bank's Lauren Lonergan Taylor.

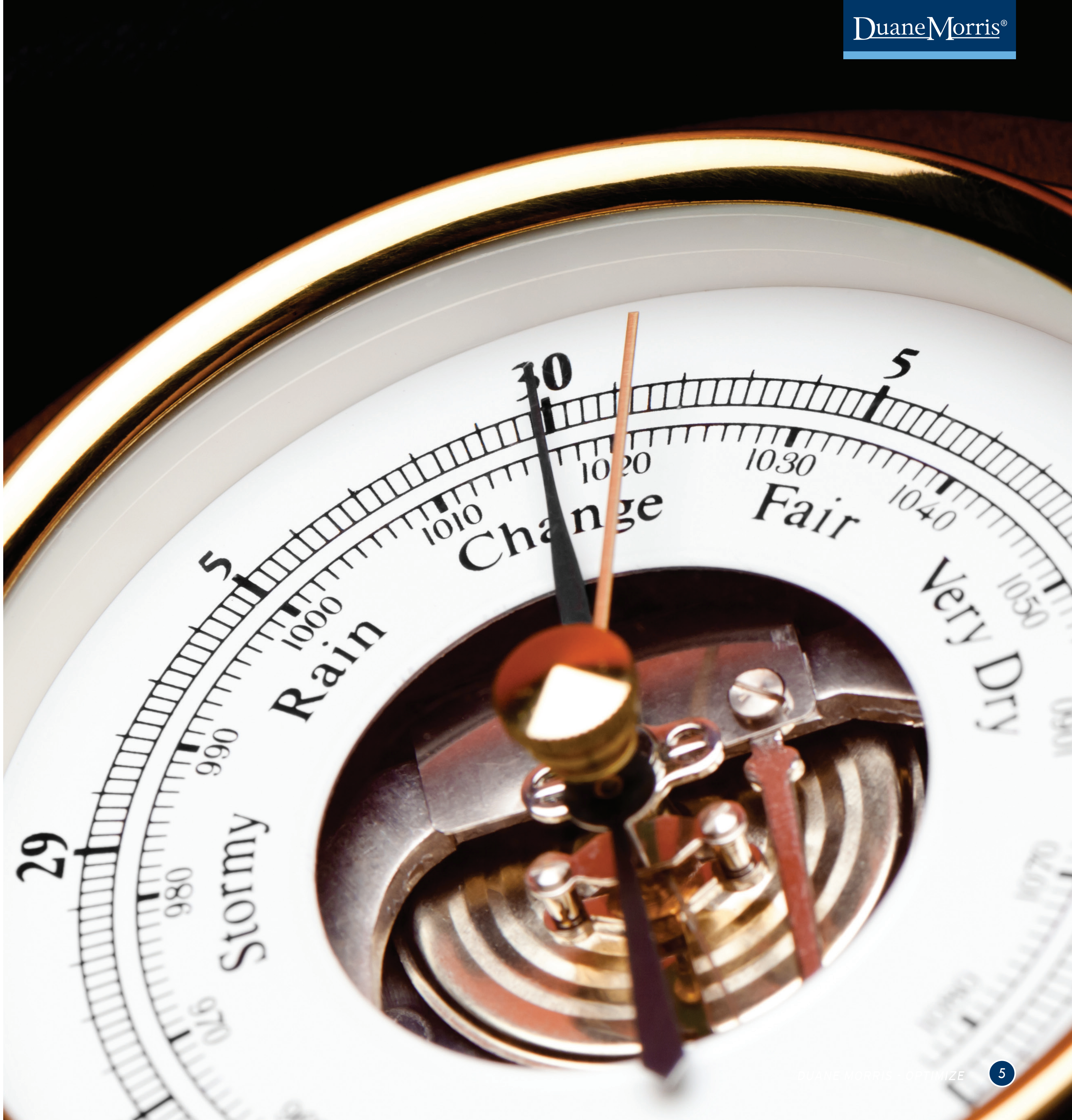
THE STATE OF COMMERCIAL FINANCE

Extreme weather. Unpredictable interest rates and yet-to-be-determined policy implications. Intensifying competition among lenders, both commercial banks and myriad alternative providers. Our lawyers and financial professionals on the panel discussed how each of these trends played out in the commercial finance space. The upshot was familiar—in more than 35 years of putting together the Business Reorganization and Financial Restructuring conference, we know that the developments we examine can change with the wind. But we also know that our clients—lenders, borrowers and others—can use our perspectives to help guide them through these atmospheric changes.

UNCERTAIN FORCES

When we held our seminar in November, potential tax reform implications on the horizon were hotly debated—but not by our panelists. (We left that up to political commentators.) Now, in 2018, nobody knows for sure who will be the long-term winners and losers when it comes to tax reform or other policy changes.

"There will be a lot of heated discussion," said Skip Di Massa, chair of the Business Reorganization and Financial Restructuring Practice Group at Duane Morris and panel moderator. "I'm sure there's going to be a lot of lobbying, and of course, some turmoil as a result. How tax code changes will impact the real estate industry, commercial debt markets, bond markets and interest rates are open questions that we will continue to track."



> “Just because you don’t see a lot of filings as a result of these situations right after the disaster, doesn’t mean they aren’t coming.”

EXTREME WEATHER

Our panelists discussed the record-breaking damage from weather events in the United States, including by Hurricanes Harvey, Irma and Maria, and wildfires that gutted areas of California. The disasters profoundly upset local economies, and will have real bearing on the insurance and commercial real estate industries in particular. Experts say that these global risks are pervasive and systemic, and affect all asset classes, industries and economies. Business leaders must consider these potential changes and how they impact capital markets, investment decisions and core business practices. For example, the cost of insurance, which was designed for less frequent and less volatile weather events, could change dramatically, and with more unpredictability than in the past. The same can be said for property values.

What changes can we expect as a result of catastrophic weather?

It depends on where the storm strikes, said Larry Kotler, a partner at Duane Morris, and how communities rebuild (or don’t rebuild). But we can look back, case-by-case, for perspective.

“Hurricane Katrina generated an increase in bankruptcy filings among those states that were hardest hit. A year after the hurricane, in 2006, while the states primarily affected by Katrina were hit with higher rates, these rates were not disproportionately higher than they were in neighboring states. But after three years, they were 50 percent higher.” That’s a trend to watch in areas hit by storms and fires.

“Notwithstanding the destruction of property as a result of a natural disaster, once people have received their FEMA or other insurance payouts, there seems to be a reduction in mortgage debt,” Kotler said. “They use it to pay down their mortgage. But from a commercial standpoint, in California alone we’re expecting over a billion dollars in estimated losses in industries, including agriculture” due to devastating fires.

When it comes to real estate development, there could be a bump in tax rates in places like California. Although construction costs will skyrocket, new structures and rebuilt areas will likely be more expensive (and valuable) than prior structures.

Victims may encounter flexibility from lenders. In August 2017, explained Kotler, the FDIC published a letter that applies to all FDIC supervised institutions, including community banks, “encouraging them to ‘consider all reasonable and prudent steps to assist customers and communities affected by recent storms.’ In other words, the Federal Reserve Board, the FDIC and the Office of Controller of Currency are telling banks, basically, ‘be nice to your borrowers.’”

Borrowers can expect lenders to waive certain bank fees, increase ATM withdrawal limits, raise credit card limits, allow customers to either skip or defer loan payments and delay any submission of delinquency notices to various credit reporting agencies for those affected by natural disasters, said Kotler. Florida and California legislators are working to enact these programs as well.

"Large banks are also taking a very flexible tone in the commercial arena," said Bob Frezza, senior managing director at Ankura, "like waiving defaults and allowing some or all of the proceeds to go back into the business to repair it."

the space if the damage is beyond repair," said Frezza. Likewise, "tenants are seeking provisions expressly releasing them from all obligations in the event of a disaster that results in destruction of the premises."

COVENANT-LITE AGREEMENTS

"We're now going to segue to man-made disasters," joked Di Massa. "We're watching the way loans are granted and deals are done. Just as they did leading up to the financial crisis, banks

> "We all saw what happened during the crisis, and we all vowed we weren't going to make the same mistakes. So why are we in covenant-lite territory here, 10 years later?"

But that's a temporary fix. Although bank flexibility helps companies impaired by the disaster to get back on their feet, after three years they can start stumbling again.

Just because you don't see a lot of filings as a result of these situations right after a disaster, doesn't mean they aren't coming.

"Lessors and lessees are more in tune with, and actively seeking, proactive provisions in leases, like including exculpation clauses, releasing the landlord from certain claims or allowing the landlord to refrain from reconstructing

are signing an increasing number of 'covenant-lite' loan agreements. Should we be concerned?"

Prior to the financial crisis of 2007-2008, of course, financial institutions held borrowers to fewer restrictions, and ultimately scores of companies couldn't pay back those loans.

Fast forward to today. The panelists said many companies now have liquidity and are hungry to do deals. They press for as few restrictions as possible in their agreements with lenders. Banks are increasingly willing to make these so-called "covenant-lite" loans. They are competing

Mairi Luce (right) discusses the past and current implications of covenant-lite loans, as Larry Kotler (left) listens.

with each other and with less regulated capital sources like hedge funds, according to the panelists.

"We all have some painful memories of the 2007-2008 meltdown, which was precipitated in large part by unregulated activity in the CMBS arena," said Di Massa. "That impending meltdown was masked, at least in part, because property values continued to rise and lenders were willing to offer no doc, no verification loans, as they were more than happy after default to take their collateral back and sell it at a profit," he said. Once the values leveled off, and defaulting borrowers continued to default, "the meltdown was really locked in."

And now, loan volume is up, said Mairi Luce, a partner at Duane Morris, who noted that nearly 75 percent of the outstanding loans up to September 2017 were covenant-lite.

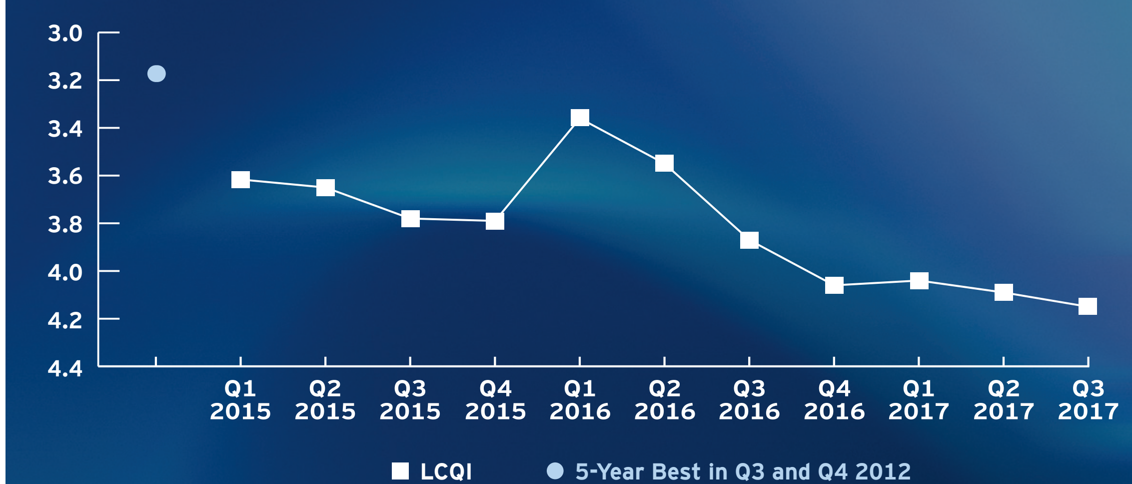
"That may be a statistic that does not surprise those of you in the audience who are bankers," said Luce. "You're dealing all the time with borrowers and borrower pushback in issues of covenants in credit agreements." She continued, "We all saw what happened during the crisis, and we all vowed we weren't going to make the same mistakes. So why are we in covenant-lite territory here, 10 years later?"

"It's supply and demand," said TD Bank's Lauren Lonergan Taylor. "There is a lot of M&A activity and that is where the competition from nonbanks is fierce, because the alternative lenders can respond to higher valuation multiples. At the lower end of the middle

TD Bank's Lauren Lonergan Taylor (right) discusses how banks should review their loan documents in light of LIBOR's phaseout. Bob Frezza (left) of Ankura, ponders the future implication of this development.

A WEAKENING TREND

Moody's Loan Covenant Quality Indicator (LCQI)



Moody's Loan Covenant Quality Indicator (LCQI) is a two-quarter rolling average. After reaching a strong score in the first quarter of 2016, the LCQI has increasingly weakened, reaching its weakest level in the third quarter of 2017.

market space, the competition among the commercial banks themselves is intense. We see lower covenant levels and cheaper pricing. Borrowers are pushing very hard to get as much leeway as they can," she said. "However, at the higher end of the middle market space, there is a bit more of a level playing field among the commercial banks because they are club and syndicated deals, and therefore need buy-in."

But in some ways, history is repeating itself, warned Kotler. "I think the one thing that's—I'm not going to say 'alarming'—is since the economic meltdown, we've noted some financial Darwinism. Troubled companies didn't survive the crisis. Companies that righted the ship became profitable." Now they have more pull, and bank workout departments have shrunk. That's a cycle that could pretty easily reverse itself.

Three-fourths of loans in 2017 through the fall were covenant-lite. Borrowers are pushing—and successfully so—to negotiate terms that are less restrictive. Taylor, who is the Head of Commercial Lending in the Legal Department at TD Bank, said borrowers and their counsel are being very vocal about the terms that they want to see, and how they want to see them in their loan documents.

Companies looking to do deals want a lot of leeway. "But smart lenders need to stand firm on the one or two covenants that matter most to them, like how to measure cash flow to service debt or the amount of leverage the bank is willing to accept," said Taylor.

LIBOR: A GATHERING STORM?

When LIBOR, the London Interbank Offering Rate, is phased out in 2021, it will have a huge influence in the United States, said Luce. The 50-year-old benchmark was originally based on the average interest rates for international banks in London to determine how much to charge for the loans they offered each other. LIBOR, said Luce, "underpins about $350 trillion in securities worldwide, but the size of the market in the United States is roughly $150 trillion. It is one of the dominant U.S. benchmark rates for loan purposes."

But when the U.K. Financial Conduct Authority (FCA) announced last summer that LIBOR would phase out, it wasn't a big surprise. LIBOR had long been subject to manipulations, say financial experts, and riddled by scandal and collusion. "It's simply unreliable," said Taylor.

When the Federal Reserve Bank of New York comes up with a replacement rate that will be gradually phased in, banks should be ready, "and they need to start that process yesterday," said Taylor.

It's crucial for lenders and lawyers to take a hard look at the language banks use in the loan documents for past, current and future loans to account for a new—and as yet unknown—rate.

WHAT'S IN *YOUR* LOAN DOC?

With respect to the LIBOR phaseout, said Taylor, there are three buckets of documents to look at.

- First, obviously, loans that are originated post-phaseout will require new language to account for the new rate. "We'll know what we're looking at then," she said.
- In the second bucket are legacy credits maturing post-phaseout. "Any commercial loan docs that are worth their weight will have language built in that have a fallback provision if LIBOR's not available," said Taylor. "We've all seen that sort of language," she said. "But we never thought we'd have to use it, right? It goes something like, 'If the lender determines in its sole and absolute discretion that LIBOR is for some reason not available, the following rate will apply.'"
- The third bucket is for loans that are originating right now. Sophisticated borrowers, well aware of the LIBOR phaseout in 2021, are already asking questions about how their banks will deal with the phaseout. Some are not willing to have their loans tied to LIBOR or they want fallback language that clearly specifies what the rate will be if LIBOR is unavailable.

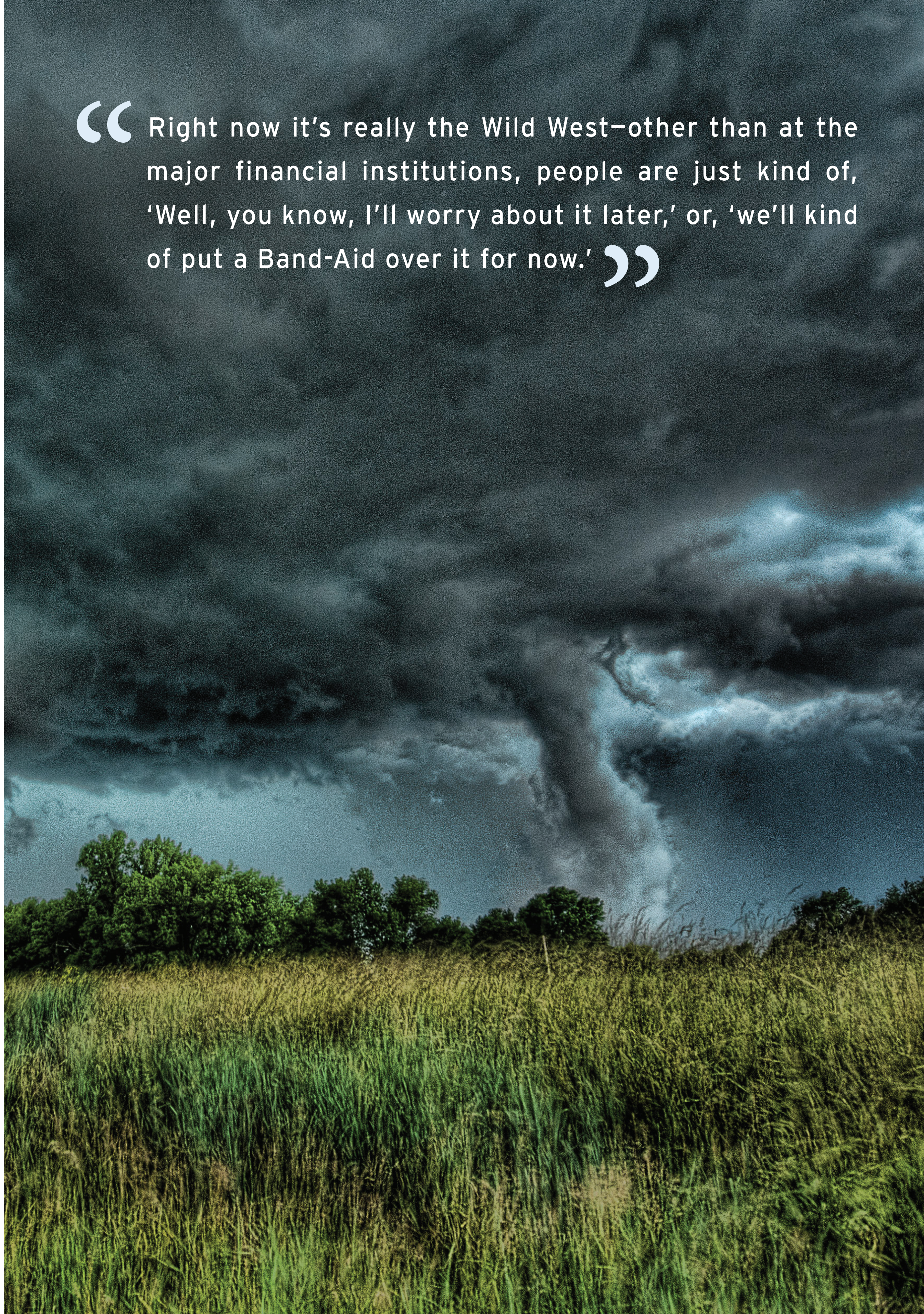
"So you just have to stop and ask yourself," said Taylor, "'What do my documents currently say, and what do I want them to say in the future?'"

"It's a challenging issue with enterprisewide implications. And we don't have clarity yet on what this replacement rate's going to be, and how it's all going to shake out," said Taylor.

The key, she advised, is to be sensitive to dealing with the rate issue in a consistent manner. "Make sure that whatever you're putting out there and agreeing to in the market with one borrower, you understand may be requested by other borrowers."

The reaction from lenders is all over the map, according to Frezza. "We polled market participants, measured regulated institutions, large seasoned hedge funds and smaller credit opportunity funds. We heard everything from 'We're not even thinking about it right now,' to 'My hair's on fire, we gotta deal with this right now!' Even among the larger regulated financial institutions, which are very focused on this for all the reasons Lauren mentioned," said Frezza, "right now it's really the Wild West—other than at the major financial institutions, people are just kind of, 'Well, you know, I'll worry about it later,' or, 'We'll kind of put a Band-Aid over it for now.'"

"And in many ways," said Taylor, "we're creating the market around the rate. It's almost like the tail wagging the dog." ■



SPEAKER PROFILES

MODERATOR

RUDOLPH J. "SKIP" DI MASSA, JR. is senior partner and chair of the firm's Business Reorganization and Financial Restructuring Practice Group. Di Massa focuses his practice in the areas of commercial litigation and creditors' rights. He currently represents various secured and unsecured lenders in bankruptcy cases pending in the Eastern District of Pennsylvania and the Southern District of New York, as well as a number of European companies doing business in the United States.

PANELISTS

BOB FREZZA, Senior Managing Director at Ankura, has more than 30 years of experience providing financial advisory services to clients across numerous industries in the United States and Europe. He is highly experienced in leading creditors and debtors through complex restructuring engagements, both in out-of-court and in-court proceedings. Additionally, he has experience in M&A and refinancing transaction due diligence projects for private equity/hedge funds, private equity backed portfolio companies, lenders and acquisitive private and publicly held enterprises.

LARRY KOTLER, a partner at Duane Morris, practices in the area of reorganization and finance, representing chapter 11 debtors-in-possession, chapter 11 trustees, chapter 7 trustees, liquidating trustees, creditors' committees, secured creditors and large institutional unsecured creditors in all facets of bankruptcy. A Fellow of the American College of Bankruptcy, Kotler is certified as a business bankruptcy specialist by the American Board of Certification.

MAIRI V. LUCE, a Duane Morris partner, practices in the areas of reorganization, bankruptcy law, creditors' rights, out-of-court workouts and complex commercial reorganizations. She represents numerous commercial banks, insurance companies and other commercial financing institutions in secured lending, asset-based lending, securitization, leasing and credit enhancement transactions and other types of commercial transactions.

LAUREN LONERGAN TAYLOR, SVP, Director and Managing Counsel, Head of Commercial Lending at TD Bank, N.A., is responsible for all legal aspects of its commercial lending operations, servicing and control matters for the corporate and specialty banking and the regional commercial banking divisions. Prior to joining TD Bank, Taylor was a partner at Duane Morris, where she represented numerous commercial banks, insurance companies and other commercial financing institutions in secured lending, asset-based lending, leasing and credit enhancement transactions, and other types of commercial transactions.

At the Sofitel Hotel in Philadelphia, moderator Skip Di Massa introduces panelists Larry Kotler, Mairi Luce, Bob Frezza and Lauren Lonergan Taylor.

ABOUT DUANE MORRIS

With experienced bankruptcy and restructuring lawyers across our domestic and global platform, coupled with the deep capabilities of more than 800 lawyers across all practice areas, Duane Morris offers the resources to optimize our clients' interests. From creditor to debtor, and trustee to committee, our bankruptcy practice is regularly recognized as one of the most active for both case volume and value of liabilities. We leverage our core experience in bankruptcy law, creditors' rights and asset recovery actions, and the full range of services for commercial mortgages and other asset classes, working with banks, nonbank lenders, special servicers, debt purchasers and asset buyers. On the distressed deal side, our lawyers have negotiated and brokered major transactions in such industries as manufacturing, real estate, telecommunications and retail. Five of the practice group's former attorneys are, or have been, sitting United States Bankruptcy Court judges, and another is a judge on the United States Court of Appeals for the Third Circuit.

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