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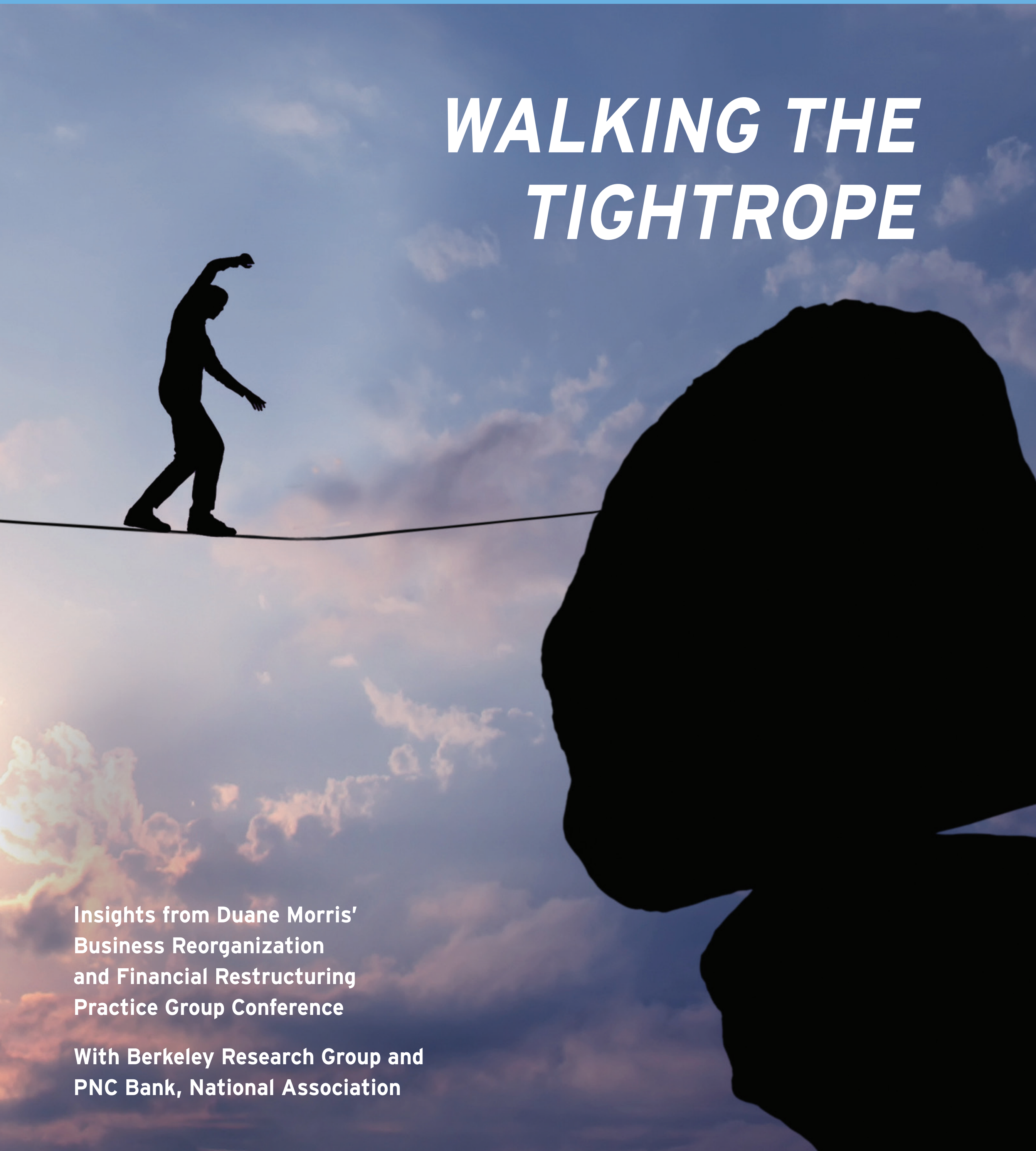

WALKING THE TIGHTROPE

Insights from Duane Morris' Business Reorganization and Financial Restructuring Practice Group Conference

With Berkeley Research Group and PNC Bank, National Association

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WALKING THE TIGHTROPE

A new balance of power and changing global dynamics will surely impact commercial finance in a significant way. But how? In the past year, potential global trade restrictions loomed. Retailers who miscalculated consumer demand lost their competitive footing. And the fear of rising interest rates had borrowers scrambling to find equilibrium. In this unpredictable political and economic climate, staying on course is like walking a tightrope. Move forward with confidence, but don't risk your neck. Which industries found themselves on the wire?

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LETTER FROM THE EDITORS

More than 30 years ago, the lawyers in the Business Reorganization and Financial Restructuring Practice Group at Duane Morris brought clients together to share on-the-ground insight about developments in commercial finance. So began an annual tradition. At our most recent seminar, together with Berkeley Research Group and PNC Bank, National Association, we discussed the forces that have shaped the current state of bankruptcy and restructuring. This sixth edition of our *Optimize* series investigates trends over the past year and anticipates the changes and challenges of an unknown future.

Jim Holman

JAMES J. HOLMAN

Partner, Duane Morris
Business Reorganization and Financial Restructuring Practice Group

JARRET P. HITCHINGS

Associate, Duane Morris
Business Reorganization and Financial Restructuring Practice Group

Amid the backdrop of creative works of art, our panelists presented their views on the current state of bankruptcy and restructuring before a captivated audience. At right, our panel (from left): Peter Chadwick of Berkeley Research Group, Jarret P. Hitchings and James J. Holman of Duane Morris, Steven J. McGehrin of PNC Bank and Haywood Miller of Berkeley Research Group.

THE STATE OF COMMERCIAL FINANCE

Frenzied financial markets and struggles to keep current on consumer demographics have exposed stress points—and even profound weaknesses—in such industries as energy, logistics, transportation, real estate, retail, restaurants and healthcare.

The changing global trade paradigm adds to the confusion. Many large and midsized companies have been keen to tear down barriers to global commerce. But the 2016 presidential campaign revealed voters' deep distrust of—or perhaps indifference to—trade deals. It remains to be seen how global growth will progress.

Bankruptcy and restructuring practitioners examine new strategies for clients struggling to find balance. Here's what our panel explored.

> As interest rates rise, small businesses will feel the heat first. Then we'll start seeing that pressure in the lower middle-market side.

ACROBATIC INTEREST RATES

Anticipating global market trends is a guessing game. Moderator James J. Holman, a partner at Duane Morris, asked the panelists to offer insight on what we *do* know. "What everyone wants to know, what our clients have wanted to know in past seminars, is what is going to happen to interest rates?" he asked.

Peter Chadwick, managing director of Berkeley Research Group in Washington, D.C., outlined the issues. First, "the decline in value of the British pound after Brexit was massive, and it will not soon rebound," he said. Next, Chadwick noted, "Our interest rates rose in 2016 and are expected to rise again soon. Then we have this constricting global economy, or at least a decelerating global economy. Nobody can know the true impact of the increased cost of capital."

Middle-market companies have built alternative lending into their capital structure, and businesses are more levered now than they were before the 2008 financial crisis. "Some can't afford to continue to pay higher interest rates," said Chadwick. "What will be the tipping point?"

Panelist Steven J. McGehrin, executive vice president at PNC Bank, agreed. "As interest rates rise, small businesses will feel the heat first. Then we'll start seeing that pressure in the lower middle-market side."

FLYING BLIND ON TRADE

With so many middle-market companies outsourcing manufacturing operations abroad, what happens on the trade front is crucial. "If companies are not able to import to the U.S., especially from Southeast Asia," said Chadwick, "it will disrupt a critical part of the supply chain."

Government contractors are already feeling the pain, said Haywood Miller, managing director at Berkeley Research Group. "The discord in Washington over trade has put budget planning on the backburner," he said. Trade policies impact government procurement competition both in the U.S. and abroad. There's not much to bank on when it comes to procurement deals, said Miller. "The big contractors are venturing down into lower-level contracts, competing against their former subcontractors. That's the mid-tier squeeze."

Restrictions on trade could stunt profit and growth, but it is not yet apparent what new policies will emerge.

WHO SAID LAWYERS CAN'T BE DAREDEVILS?

At the age of 18, Jules Léotard, the famous 19th-century trapeze artist, had studied to be a lawyer and had passed his law exams. Instead, he followed his passion and joined the Cirque Napoleon in Paris. In 1859, Léotard became the first person to perform a somersault in mid-air, and the first to jump from one trapeze to another. Léotard was the inspiration for the popular 1867 song, "The Daring Young Man on the Flying Trapeze," and his tight one-piece costume inspired the modern-day leotard, named after Jules himself.

Jules Léotard, the would-be lawyer who wowed circus audiences in the 1860s.

"There's not much to bank on when it comes to procurement deals. The big contractors are venturing down into lower-level contracts, competing against their former subcontractors. That's the mid-tier squeeze."

A FINE LINE IN EXPLORATION AND PRODUCTION CASES

Houston E&P company Sabine Oil & Gas Corp's chapter 11 reorganization revealed the changing dynamics between E&P companies and the midstream entities entrusted to gather and transport oil and gas to market.

Like many energy companies, Sabine faced the devastating combination of sinking oil prices and overflowing debt. To restructure its balance sheet to stay afloat, Sabine wanted to shed costs and obligations. One of those burdens were so-called "running with the land" agreements that it had previously entered into with two midstream companies. E&P companies like Sabine want to reject these covenants. Midstream companies contend that the covenants are enforceable under Section 365 of the Bankruptcy Code.

Judge Shelley Chapman of the Southern District of New York ruled that Sabine had the right to reject gas-gathering and related agreements with midstream entities.

"Once this ruling came down," said Hitchings, "all of those cases almost immediately settled. If the Second Circuit affirms the district court, it could deter investment in energy infrastructure projects."

LOGISTICS AND TRUCKING

"The raft of energy filings has impacted logistics entities involved in transporting energy products," said Holman. "The market is very depressed. These companies are under severe pressure to require their borrowers to unload excess equipment."

Added McGehrin, "There's just a huge overcapacity of trucks on the road today, and despite lower fuel prices, there's still a drop in demand."

"We see it in the mom-and-pop companies that owned and financed their own trucks," said Chadwick. "Their credit limited the size of their borrowings and the size of their fleet. But when alternative financiers jumped in offering the ability to build large fleets with hundreds of trucks," the trucking companies saw dollar signs.

"They viewed these credits as asset-based loans, without really any thought to, 'well, what's the cash flow underlying all of this?'" said Chadwick. "Even if demand went up, there aren't enough drivers to drive the trucks."

INDUSTRY SNAPSHOTS

ENERGY

"Energy is in massive upheaval," said Chadwick, noting that in the past year, the three-largest producers of oil and gas in the United States all filed for bankruptcy. "The flood will continue in the energy space," he said.

The dynamics of these bankruptcies and restructurings are shifting. When oil and gas prices were really tanking, the secured lender determined the plan and the outcome. "They were able to basically jam it down everyone else's throats," said Chadwick. As values have appreciated, more and more players found a seat at the table, making bankruptcies more complex.

It's a boon for energy lawyers, said Duane Morris associate and panelist Jarret P. Hitchings. "Just about every Delaware bankruptcy lawyer worth their salt has done the homework in oil and gas law, including things like the esoteric principles of North Dakota mineral rights," he said. "They have to."

"The question is whether the dominoes are going to fall on midstream gatherers, the folks who build the pipeline infrastructure," said Hitchings. "*In Re Sabine*, a case pending in the Second Circuit, highlights how midstream companies could lose some ground." [See sidebar on page 10.]

RETAIL

The retail sector is also pinched. Disruptions, including shifts in consumer spending behavior and intense competitive pressures, have taken major retailers off-guard. "In many cases, the value of their real estate is potentially more profitable than their business operations," said Hitchings. For example, "Department stores like Macy's have sold space to mall developers, who in turn break it up and lease the property to other stores."

Sports Authority is another company that miscalculated its market value, said Hitchings. "When they went into chapter 11, they expected that retailers like Dick's Sporting Goods or Modell's might take their footprint. But the buyers just weren't there. Sports Authority liquidated a good number of its stores at minimal value. Its brick-and-mortar operation was too expensive."

Other miscalculations have hurt retailers, added Chadwick. "The younger generation is far more cost-conscious and less brand-sticking than prior generations. They're very comfortable shopping online," he said. "Many in the retail sector didn't see that coming."

"If a retail company goes into bankruptcy," said Miller, "it's very difficult to emerge as the same company. The value of liquidating is dramatically better than trying to revitalize a failing brand."

RESTAURANTS

The restaurant industry is experiencing a shakedown, said Hitchings, especially corporate-owned restaurants like Così and Garden Fresh. Restaurant openings have simply outpaced demand.

"Over-expanded restaurants are trying to shed some of these leases to right the ship," said Hitchings.

Added Holman, "I think one of the main lessons from those cases is that, if there's not a buyer, there's not a brand—as soon as that becomes obvious, the brand name becomes virtually worthless."

> "... we may have a wall of maturities and defaults relating to dog real estate, but as far as those backed by prime real estate, we may be seeing the end of that nightmare."

Retail businesses are very susceptible to trends. "Something hot six months ago becomes suddenly passé and no one will touch it," said Miller. "Particularly with the young folks, in retail and restaurants, there are just so many choices available to them. Any brick-and-mortar expansion is a big risk. It's much better to stay flexible."

HEALTHCARE

The Affordable Care Act's impact is rough on providers, said Chadwick. "Haywood and I do work with a lot of skilled nursing facilities, long-term care facilities and acute care facilities," he said. "Many of them are not capable of managing their billing systems in a timely way and end up in liquidity trouble because the federal government is very focused on proper billing. It can hold up your reimbursement," he said. For those that have not adapted to the ACA's model that rewards caring for fewer people at a higher billing rate, "they end up getting cut in their reimbursement rates."

Added Miller, "There are just a lot more insureds out there, and the insurance companies don't want to participate in these exchanges. Many facilities haven't really complied with ACA, and they are slowly deteriorating. The only thing propping them up is money from the federal government, the states and Medicaid payments."

"There's no obvious solution to this serious problem," explained Miller. "There's hundreds and hundreds of community hospitals and thousands of senior living facilities serving Medicaid populations. Reimbursement is doing nothing but going down. Banks have few options. It's very difficult for a bank in a community to shut down the one hospital within a hundred miles."

Duane Morris' Fall 2016 Bankruptcy Seminar was held at the Pennsylvania Academy of the Fine Arts - Samuel M.V. Hamilton Building in Philadelphia.

COMMERCIAL REAL ESTATE

"Last time we gathered for this seminar, we reported on the wall of maturities coming due on the commercial real estate front with CMBS facilities," said Holman. "CMBS facilities, of course, are mortgaged-backed or commercial mortgage-backed securities that reached their high-water mark right before the financial crisis. We are now in the middle of those loans terming out," he said. "The fact that many of these securities were backed by less-than-ideal real estate—well, there was a very bleak prospect that there would be any refinancing sources."

Our forecast came to fruition, said Holman. "There are upwards of $14 billion worth of commercial mortgage-backed securities maturing every month, and that will continue well into 2017."

The good news is that commercial banks are increasingly starting to lend to commercial properties now, and "we're seeing proposals with relatively low interest rates," said Holman. "Less attractive properties will not be lapped up by commercial banks," he noted. "That sector may have to go through a fairly painful adjustment." In other words, "we may have a wall of maturities and defaults relating to dog real estate, but as far as those backed by prime real estate, we may be seeing the end of that nightmare."

Time will tell how economic, political and cultural forces will settle. But one thing is certain: When you're flying high, it's a good idea to have a strong safety net. And a good lawyer.

SPEAKER PROFILES

MODERATOR

JAMES J. HOLMAN is a partner at Duane Morris LLP. Holman practices in the areas of commercial finance law, business reorganization, business and municipal insolvency, and complex asset planning. He represents institutional lenders, trust companies, insurance companies and businesses in a broad spectrum of transactions, including corporate finance, asset sales and planning structures, business restructuring and bankruptcy.

PANELISTS

JARRET P. HITCHINGS is an associate at Duane Morris LLP. He practices in the areas of commercial finance, financial restructuring and business bankruptcy. Hitchings has represented agents, lenders and borrowers in financial transactions, such as restructurings, and has experience in bankruptcy and commercial litigation, including representation of debtors, appointed committees and liquidating agents. He is a founding lawyer of pro bono group Philadelphia VIP's Consumer Finance Project.

PETER CHADWICK is Managing Director of Berkeley Research Group in Washington, D.C. He helps underperforming businesses and advises debtors and creditors in complex restructuring matters. He has served as chief restructuring officer, chief executive officer, chief operating officer, chief financial officer and advisor to companies in a variety of industries. Chadwick has led restructurings in manufacturing, production and construction, including renegotiating contracts with original equipment manufacturers and creditors, effectuating sale transactions and preparing business plans.

HAYWOOD MILLER is Managing Director at Berkeley Research Group in Washington, D.C. He has more than 30 years of experience as a business owner, workout professional, private equity and debt investor, and securities and mergers and acquisitions lawyer. With Capstone Advisory Group and BRG Capstone, Miller has led teams working in sectors that include healthcare, government contracts and pharmaceuticals, as well as other companies in financial distress. Prior to that, Miller served as general counsel and was a senior executive at a number of publicly traded companies.

STEVEN J. McGEHRIN is Executive Vice President Credit Policy at PNC Bank. McGehrin manages the Mid-Atlantic region for PNC's asset resolution team. He handles workout and related resolutions on both commercial loans and syndicated loans.

From left: Peter Chadwick of Berkeley Research Group addresses the panel, with Jarret P. Hitchings and James J. Holman of Duane Morris, Steven J. McGehrin of PNC Bank and Haywood Miller of Berkeley Research Group directing their attention toward his remarks.

ABOUT DUANE MORRIS

With experienced bankruptcy and restructuring lawyers across our domestic and global platform, coupled with the deep capabilities of more than 750 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, non-bank 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 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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