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VALUE FROM DISTRESSED ASSETS

EMERGING CONTRADICTIONS:

INTERPRETING DISPARATE TRENDS IN THE WORLD OF COMMERCIAL FINANCE

Insights from Duane Morris' Business Reorganization and Financial Restructuring Practice Group Conference With Berkeley Research Group, LLC and BRGCapstone

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EMERGING CONTRADICTIONS

__Talk about contradictions:__ Despite such solid fundamentals as record-high corporate profits, a strong dollar and falling gas prices, U.S. voters still embraced President Obama's opposition in the 2014 midterm elections. With the uncertainty of the upcoming presidential elections on the horizon, we focus on paradoxes, politics and the landscape's dearth of predictability.

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LETTER FROM THE EDITORS

Ambiguity is a fact of life. As Benjamin Franklin observed, only death and taxes are certain. It's also a fact that predicting how bankruptcies will shake out in the rest of 2015 and beyond in the current economic and political climate can seem like a best-guestimate exercise, especially in the midst of incongruous trends. To give our clients an edge, Duane Morris brings together sophisticated bankruptcy law practitioners and financial analysts to provide their take on what lies ahead. Our last seminar explored the economic and political forces at play and helped clarify some of the potentially confusing contradictions from last year, while uncovering scenarios to anticipate. We hope you find this fourth edition of our *Optimize* series informative and interesting, and we welcome your questions and comments.

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EMERGING CONTRADICTIONS: AN OVERVIEW

Duane Morris partner James J. Holman moderated our panel discussion, which featured Peter Chadwick and Haywood Miller of BRG, along with Duane Morris partners Mairi V. Luce and Lauren Lonergan Taylor. Holman began by framing recent paradoxes:

"Within the past 18 months, corporate profits have been at record highs, the country added about 200,000 jobs per month, unemployment was below 6 percent, the U.S. Gross National Product was the best of all the OCED countries, the dollar was at its strongest level in years, the stock market was near record highs, gasoline prices have fallen, there is virtually no inflation, interest rates are the lowest in 30 years, U.S. oil imports are declining, U.S. oil production is rapidly increasing, the deficit is rapidly declining, and, last year, U.S. voters handed control of both houses to the president's opposition."

"If that's not a contradiction, I don't know what is," said Holman. "So something is clearly amiss here." These inconsistencies lend themselves to an examination of how the bankruptcy landscape unfolds across sectors of the U.S. economy. After all, noted Holman, "In 2012, the federal government did about $516.3 billion worth of business with private contractors. In 2013, the federal government shut down."

In an economy of surprises, what comes next? What industries will be impacted?

GOVERNMENT CONTRACTED

Peter Chadwick of Berkeley Research Group noted: "Sequestration will continue to be a part of our lives—a forced contraction of government spending." Government contractors "will fight for a smaller and smaller pie. There is a reduction in the purchases of a variety of products, but also in the outlays to the contractors."

Added BRGCapstone's Haywood Miller, "Fifteen or 20 years ago, government contractors were not interesting to banks or private equity. Then, suddenly, there was an outsourcing boom, the various Iraq wars came, and there was an absolute explosion of government contractors. Private equity and banks got involved." But, he noted: ***"A lot of these companies are relatively low-margin operations. We see more of them dressing themselves up as tech plays, but they are often body shops that are putting bodies in seats. There is a squealing in D.C. that is pretty substantial."*** At the end of the day, Miller

"Sequestration will continue to be a part of our lives—a forced contraction of government spending."

continued, “The small businesses are going to get their piece of the pie. The mid-tier companies are getting squeezed. The big companies want to maintain their top line.”

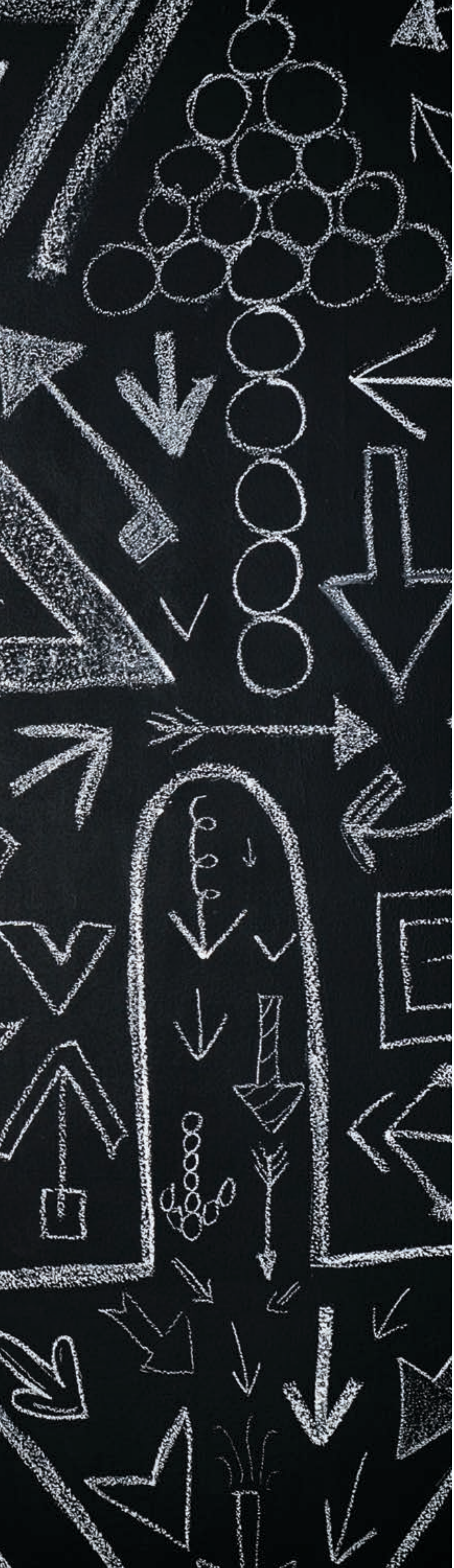
Just look at the space where it’s often easiest for the government to reduce purchases, added Chadwick, “like IT groups, body shops and telecommunications. In some cases, they disappear overnight. Their capital is human. They are like a school of fish, and all of their employees leave and follow the contract over to another provider. They typically are not acquired. There is relatively little M&A in that space. The big companies come in and take the contracts.”

COAL AND MINING – RIPE FOR CHAPTER 11

Noted Chadwick: "There is no industry more affected by the changing dynamics imposed by government and other economic forces as mining. The United States has long been the 'Saudi Arabia of coal.' And through a combination of microeconomic forces, the supply of coal is growing to a point where prices are significantly depressed. The demand is collapsing and moving overseas."

Six coal and mining companies have filed for bankruptcy in the past two years, said Chadwick. "It reminds me of the automotive industry 10 years ago, with these very rigid cost structures," he added. Yet there are limitations in those filings; not all of the environmental liabilities can be expunged through chapter 11. While they are ripe for bankruptcy, it's not the panacea you may think it is to deal with all of the issues the coal industry faces.

From left: BRGCapstone's Haywood Miller and Duane Morris' Lauren Lonergan Taylor direct their attention toward Duane Morris' James Holman as he frames the recent paradoxes in the U.S. economy and their impact on the bankruptcy landscape.



FOR-PROFIT EDUCATION SECTOR – WAKING FROM THE AMERICAN DREAM

When for-profit schools came to the forefront, said Miller, "The government jumped in with both feet, supporting them because it was so politically popular." However, student loan default rates have been skyrocketing. "The default rates on the student loan debt are higher than the graduation rates at these schools," Miller noted. *"Congress is now alarmed. A lot of education companies are not going to make it."*

Interestingly, for-profit educational institutions cannot file for bankruptcy because they would lose their federal funding. About 90 percent of funding for these schools comes from the federal government. They have to work out their issues outside of filing, said Miller. "That reduces the leverage everyone has to get a deal done. You have to involve the Department of Education in that plan. That Department doesn't always have the same economic incentive that a lender might, so it makes the workout plan that much more difficult."

"You need to have a plan," added Miller. "Either to sell it to someone else or restructure yourself. Focus on operational things. Spend more on curriculum. Focus on one or two areas rather than 15. If you are an honest company, the government is going to want to work with you, so that's the good news."

GAMING INDUSTRY

The gaming industry is on watch. During the panel, Holman outlined the story of the Revel Hotel and Casino in Atlantic City, N.J. "Revel was to be a virtual indoor city with dining—a $2.2 billion project, to be constructed in 2008, just prior to the economic collapse." After the collapse, the casino suffered a huge hit. After a significant write-down, it opened in 2012 with $1.1 billion in debt. "The property was never profitable, and Hurricane Sandy dampened crowds," said Holman. It finally filed for bankruptcy protection in January 2013, with a pre-pack that brought the debt load down to $272 million. After months of operating at a loss, the project collapsed in June 2014. Revel filed for chapter 22 on June 14, and after being coaxed by Governor Christie, it closed on September 2.

The lesson: While many states are trying to take advantage of this form of revenue, it's a limited market. It's saturated. And the industry is changing and under pressure. Still, said Holman, "It's like catnip for governors and voters."

Duane Morris' Lawrence Kotler is engaged in a thoughtful exchange of ideas inspired by the program.

"And the industry is changing and under pressure."

CREDIT BIDDING BATTLES

What do the economic and legal landscapes mean for credit bidders? Lauren Lonergan Taylor, a partner at Duane Morris, outlined cases that have chipped away at the right of secured creditors to credit bid in a bankruptcy case.

"Credit bidding," Taylor said, "traditionally has been like an unalienable right in bankruptcy—the right of a secured creditor to bid up its debt in lieu of paying cash when there is an auction of assets."

A few years ago, the U.S. Court of Appeals for the Third Circuit in *In Re Philadelphia Newspapers* issued an opinion that limited a secured creditor's right to credit bid when a sale of assets was being effectuated through a plan of reorganization, as opposed to through a separate Section 363 sale. The court said that a secured creditor did not have a right to credit bid as a matter of law, as long as the plan had otherwise provided it with the indubitable equivalent value of its claim. "That case was ultimately overturned by the U.S. Supreme Court, and secured creditors everywhere drew a sigh of relief," said Taylor.

Other cases have further whittled away at creditors' bidding, noted Taylor, including *In re Free Lance-Star Publishing Co.*, a case that involved the purchase of distressed debt at a discount by a buyer who wanted to acquire the debtor's underlying assets. In the end, the purchaser's right to credit bid was limited. (See Sidebar, *In re Free Lance-Star Publishing Co.*, for a detailed discussion of this case.)

"We are already seeing the effects of these cases in practice," said Taylor. "For example, in Delaware, some of the judges are now requiring that if a DIP order grants a right to credit bid for assets in the case, the language allowing the credit bid must also contain verbiage that protects the court's right to find cause to limit the credit bid. It's usually language saying secured creditors have the right to credit bid unless the court for some reason finds otherwise. So we're seeing that the courts are certainly paying attention to these cases and putting some limitations into practice."

"These cases are a real shot across the bow for buyers of distressed debt," maintained Taylor. "There's nothing impermissible *per se* about a loan to own strategy, but you really have to think about how that strategy is played out. These cases illustrate the erosion of predictability that we've seen elsewhere."

IN RE FREE LANCE-STAR PUBLISHING CO.

"The debtor's secured lender," explained Taylor, "was a local bank that had a blanket lien on nearly all of its assets, but there was a group of assets on which the bank did not have a lien. Those assets were referred to in the case as the Tower assets because they related to the debtor's broadcasting business. Once the debtor's loan went into default, the bank decided to sell the loan, and the buyer of the loan, the new secured creditor, embarked on what the court ultimately saw as a rather aggressive pre-petition strategy vis-à-vis the debtor."

The first thing the secured creditor did was to ask the debtor to sign security agreements granting the secured lender a security interest in these otherwise-unliened Tower assets. The debtor refused to do that. Unbeknownst to the debtor, the secured creditor filed Uniform Commercial Code financing statements purporting to perfect a lien on those Tower assets even though it hadn't ever been granted one. "It then kind of eased up its pressure on the debtor to hurry up and file for bankruptcy," said Taylor, "[and] then allowed the 90-day preference period to pass. Once the 90-day period had elapsed, it put the full-court press back on the debtor, on the company, to gear up for a bankruptcy filing."

"Post-petition, not one to give up easily, the secured creditor went to the court asking, as additional adequate protection for its claim, for the bankruptcy court to grant it a lien on the unliened Tower assets," said Taylor.

"Interestingly, in the course of asking the court for that, the secured creditor never disclosed that it had already filed financing statements purporting to perfect a lien on those assets." The court declined the request, but the failure to disclose that to the court did not work in the creditor's favor. The debtor moved toward a sale of its assets in the bankruptcy via an auction, and its secured creditor was very involved in the process and pursued again a relatively aggressive strategy. It insisted that the marketing materials distributed to potential bidders have a header across them, noting the secured creditor's right to credit bid up to $39 million and to credit bid for all of the assets, as opposed to just the assets on which it clearly had a lien, i.e., not the Tower assets. The debtor finally went to the court and asked it to make a determination on the creditor's lien, as well as to limit the secured creditor's credit bid for the assets. The court found there was cause to limit the secured creditor's credit bidding in the case, as a result of what it perceived to be inequitable conduct by the secured creditor.

Taylor summed up the results: "The court really found that the actions of the secured creditor had in fact served to depress the value of the debtor's assets because of testimony in the case that potential bidders were actually very confused by the marketing materials, were not aware what assets in fact the secured creditor had a valid lien on, how much its bid could be and to which pool of assets it applied. Instead of enhancing the value of the assets like an auction should, it had in fact depressed the value of the debtor's assets. The court limited the secured creditor's bid to $14 million rather than $39 million."

> "Sponsors are under stress themselves, having to raise new funds. It's a tough world out there, even for sponsors."

EQUITY SPONSOR DEALS

Equity sponsor deals, where banks are generally brought in more as liquidity providers than anything else, have a real downside for secured lenders. Said Chadwick: "Clearly over the last several years, the process by which the sponsored loans have been managed has changed. For a long time in leveraged buyouts, the relationship between sponsors and money market lenders was symbiotic. Now, sponsors have decided to cut bait on some of their portfolio companies, the relationship with their lender be damned."

Lenders are left holding the bag—having to fund the ultimate outcome for that credit. Lenders are

A moment of reflection is captured, with (from left) Duane Morris' James Holman, BRG's Peter Chadwick and Duane Morris' Mairi Luce absorbed in the discussion on equity sponsor deals.

under pressure not to do the leveraged loans. That relationship is not the same as it was 10 years ago, when money market banks would rely on the sponsors for a pipeline of work.

Said Miller: "Sponsors are under stress themselves, having to raise new funds. It's a tough world out there, even for sponsors."

MUNICIPAL DEBT SECTOR DYNAMICS

Mairi V. Luce, a partner at Duane Morris, provided the panel an example of a Pennsylvania state statute that affects municipal insolvency filings, which serves as a microcosm of how political and legislative pressures can create what appears to be a contradiction.

In order to file for chapter 9, the state within which the municipality resides has to permit that specific type of municipalities to file. While Pennsylvania permits municipalities to file for relief under chapter 9, the municipalities must first qualify to file by complying with a state statute. As a result, chapter 9 has been used very little in Pennsylvania.

"What's interesting about Pennsylvania," said Luce, "is a very arcane or little-known statute, Pa. Act 47, the distressed debt statute for municipalities that are in economic distress. It was enacted in 1987 during a period in which coal- and steel-producing regions in Western Pennsylvania had to shut down plants due to economic stress. The Act was created as a way for those municipalities to restructure. But years later, many municipalities have never left Act 47: Out of 26 that went in, only nine have emerged. A couple of million people in the commonwealth, including people who live in places like Harrisburg, Pittsburgh and Scranton, are living under Act 47."

Luce says people have gotten excited about chapter 9 filings, with the cases in Detroit and in Jefferson County, Alabama; along with a number of cases in California, *but in Pennsylvania, chapter 9 is rarely used as a tool for municipalities to recover from economic stress.*

Now the Pennsylvania Legislature has revised Act 47, giving further taxing powers to municipalities so they can raise additional revenue and exit Act 47 more quickly. It remains to be seen whether this will help Pennsylvania municipalities recover more quickly from economic distress.

Concluded Luce: "Pennsylvania's use of Act 47 reflects a microcosm of what we have been discussing on this panel. How Main Street can look so different from Wall Street. Act 47 explains why municipalities in Pennsylvania don't file for chapter 9, even in a state of distress—another seeming contradiction."

SPEAKER PROFILES

MODERATOR

JAMES J. HOLMAN is a Partner at Duane Morris LLP. Mr. 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. He also provides advice on matters affecting wealth and asset planning for high net worth individuals. He is listed annually *by Chambers USA: America's Leading Lawyers for Business* and *Best Lawyers in America*, as well as by the London organization Citiwealth, as a leading lawyer in the United States.

PANELISTS

PETER CHADWICK is a Managing Director at Berkeley Research Group, LLC (BRG). As a Managing Director, Mr. Chadwick has significant operating experience that includes improving underperforming businesses and advising 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. Mr. Chadwick has extensive experience in leading restructurings in manufacturing, production and construction, including renegotiating contracts with OEMs and creditors; effectuating sale transactions; and preparing business plans based upon his manufacturing rationalization studies, operational restructuring plans and global sourcing and distribution analyses.

MAIRI V. LUCE is a Partner at Duane Morris LLP. Ms. Luce 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. In addition, Ms. Luce represents both lenders and borrowers in secured-finance transactions in which collateral is located outside the United States in jurisdictions in Central and North America, Europe and Asia.

H. HAYWOOD MILLER III is a Managing Director at BRGCapstone. Mr. Miller has more than 20 years of professional experience as a workout professional, as well as a private equity and debt investors and mergers and acquisitions lawyer. Prior to joining BRGCapstone, Mr. Miller was a corporate lawyer and a C-Suite executive with operating and investment firms, and he has extensive experience as a principal in distressed and non-distressed transactions in the healthcare, financial services, contracting, manufacturing and business services industries.

LAUREN LONERGAN TAYLOR is a Partner at Duane Morris LLP. Ms. Taylor practices in the areas of commercial finance, secured transactions, business reorganization, financial restructuring, creditors' rights and bankruptcy law. She represents numerous commercial banks, insurance companies, non-institutional lenders and borrowers in secured lending, asset-based lending, leasing and credit enhancement transactions and other types of commercial transactions. She has assisted both creditors and borrowers in complex workout, restructuring and insolvency matters in connection with the enforcement of remedies through commercial litigation in federal and state courts. Ms. Taylor has significant experience with the resolution of troubled loans through forbearances, extensions and loan sales, including with respect to securitized commercial mortgage loans, commercial mortgage-backed securities and conventional real property loans. Her diverse practice also includes the representation of court-appointed receivers in connection with lender mortgage foreclosure actions. In addition, Ms. Taylor has represented chapter 11 trustees, creditors' committees, liquidating trustees and secured and unsecured creditors in all facets of bankruptcy.

Our panelists and moderator convene at our insightful and stimulating program aimed at examining the contradictions at play in the world of commercial finance. From left: BRG's Haywood Miller, Duane Morris' Lauren Lonergan Taylor and James Holman, BRG's Peter Chadwick and Duane Morris' Mairi Luce.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ABOUT DUANE MORRIS

With experienced bankruptcy and restructuring lawyers across our domestic and global platform, coupled with the deep capabilities of more than 700 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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