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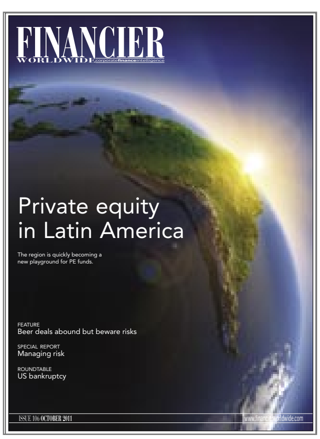
ROUNDTABLE

US BANKRUPTCY



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U S B A N K R U P T C Y

R O U N D T A B L E

US BANKRUPTCY

The US business environment remains tough. Early signs of economic recovery were wiped out when the second quarter stalled, due largely to the government's debt ceiling crisis. Meanwhile, distressed companies continue to opt for section 363 sales and liquidations over Chapter 11 restructurings, and the shock of the credit downgrade has hit those already struggling in a weak recovery. However, these challenges are not insurmountable – there are still opportunities for debtors and their bankruptcy advisers to work together to effect positive change and revitalise fortunes. ▸▸

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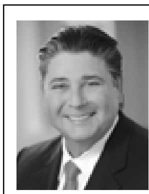

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Jay M. Goffman is the global leader of Skadden's Corporate Restructuring Group. He was named among 'The Decade's Most Influential Lawyers' by The National Law Journal in March 2010 and was recognised as one of The American Lawyer's 'Dealmakers of the Year' in April 2011 for his work in restructuring Metro-Goldwyn-Mayer, Inc. (MGM). Mr Goffman is regularly selected as one of the leading restructuring lawyers in the country and the world.

Berman: What is your take on the US bankruptcy market over the last year or so? What activity have you seen in terms of Chapter 11 filings, liquidations and general corporate distress?

Chatz: I have previously used the word tepid to describe the US bankruptcy market over the past year or so. That remains the case. More than ever, Chapter 11 filings are leading to liquidation and sale of businesses through an orderly 363 sale process. Foreclosure initiated real estate filings are increasingly prominent as debtors make often-futile attempts to preserve value for the benefit of equity holders. We are also seeing more fraud tainted business filings, initiated either by secured creditors or unsecured creditors through involuntary bankruptcy proceedings. The good news is that secured creditors seem to have more appreciation for the ongoing business value of distressed companies that may be technically out of covenant but which are paying their bills.

Perkins: Without a doubt, Chapter 11s, particularly large Chapter 11s, slowed substantially in the last year. There were some marquee deals, but the overall volume in the mega-market was substantially slower. The middle market, however, was busier. As for liquidations, we are focused on the corporate distress side of things so I spend less time in this business, but the major downsizing of so many markets has caused many high profile liquidations which suggest that this market is also busy. Corporate distress is still prevalent. It is a 'have and have not' market now. Large companies have managed to increase profits and cash flow by virtue of cutting costs, including labour. These companies also had access to a robust high yield market, and low interest rates from traditional lenders. Capital was available and/or cheap for the large-cap survivors. Middle-market companies did not have access to that same capital, especially those with even a modicum of distress.

Sprayregen: The US bankruptcy market over the last year or so has been quite choppy. We have continued to see a great deal of activity in the real estate sector, particularly hospitality. However, the large industrial corporate reorganisation cases that we saw from 2008 to 2010 have largely concluded and very few new large industrial cases have taken their place. I characterise the market as a steady trickle at this point rather than as either dead or robust. General corporate restructurings continue to exist but more in the stressed area rather than distressed, largely as a result of the capital markets, particularly the high yield bond market, having been wide open until just recently.

Carson: Corporate distress levels remain at record lows. We have seen a dramatic shift from large-to-small company Chapter 11 filings over the last few years. In the first half of 2011, only three debtors of the top 20 cases have assets worth more than $1bn. Cases are on average 94 percent smaller than those in 2009 and the largest filing in 2011 would have been ranked tenth in 2010 and would not have made the top 20 list in 2009. Today, those companies dealing with debt maturities find themselves able to refinance debt as interest rates continue to hover around zero percent. We've seen the trend continue towards transaction-based filings from prepackaged or prearranged bankruptcies to Section 363 asset sales, in an effort to more quickly shed non-performing assets versus undergoing a traditional corporate restructuring.

Bankruptcy filings in the US are clearly down from the past few years. Given the uncertainty of the economy, secured parties are more willing to allow a struggling business to remain in status quo while the larger scope of the economy corrects itself.

CHRISTOPHER A. WARD

Ward: Bankruptcy filings in the US are clearly down from the past few years. I believe that this is mainly due to the current, and continuing, economic crisis. Given the uncertainty of the economy, secured parties are more willing to allow a struggling business to remain in status quo while the larger scope of the economy corrects itself. Lenders would rather let a borrower tread water for a year or two instead of forcing a bankruptcy filing that may not be as advantageous, or even warranted, in the present economic climate. Once businesses start to generate more revenue as the global economy stabilises itself, then lenders will become more aggressive with their borrowers to share in that increased revenue, which may lead to additional bankruptcy filings in the future.

Goffman: While the number and size of Chapter 11 filings are certainly down, over the last year or so, our corporate restructuring practice has continued to be strong. We view 'corporate restructuring' as assisting any company with a 'leverage issue'. When the credit markets are open, as they have been for the past year or so, we tend to do more refinancings, amendments, exchange offers, tender offers and out of court distressed M&A deals. When credit markets tighten, as they did in 2008-09, we do more prepacks, prearranged plans and 363 sales. It is only when credit markets completely shutdown, like at the end of 2008, that you tend to see a significant amount of traditional Chapter 11 cases.

Berman: Which sectors currently seem to be experiencing fundamental structural weaknesses?

Perkins: There are a handful of industries that are experiencing structural weakness, but I think the real weakness is more related to situational weakness rather than structural. If there is an industry that is very weak, it would be commercial real estate. That said, other industries that I see having structural weakness are manufacturing, particularly certain sectors of aerospace, some wholesale/value-added distribution, and retail. Some of the themes in those have been over-played, but domestic material and labour prices are playing against us, as well as higher fuel/transportation prices. All of these domestic problems are highly correlated with ▸▸

the increase in competition, sophistication, and demand within the ever-more-competitive world, particularly within the BRIC nations as well as many other less famous developing nations.

Sprayregen: Real estate is demonstrating the most fundamental structural weakness of any sector at the present time, in addition to any businesses exposed to the housing marketing, including construction materials, equipment rentals businesses, and the like. The real estate area has recovered and stabilised to some extent, however, there are still many overleveraged deals that need to work their way through the system. While not quite a 'sector', a number of the PE deals done at the height of the market in 2007 and early 2008 remain semi 'zombie-like' in that their enterprise value and future cash flow may not support their capital structure, but there is no imminent liquidity event due to the fact that current cash flow remains sufficient and covenants are light.

Carson: History has shown that all sectors experience cycles that are dependent upon the performance of the financial markets. No sector was left unscathed in the aftermath of the US financial crisis. However, a greater indicator of fundamental structural weakness resides in the difference between large or mega-size companies and the small to mid-size market's ability to access capital. These smaller companies typically look to local or regional financial institutions to borrow funds. Unfortunately, these lenders continue to experience their own challenges with industry consolidation or government take over. A recent development in challenged sectors involves alternative-energy companies. So far in 2011, three solar-energy companies have filed for Chapter 11 as a result of pulled-back government subsidies, reduced market demand and increased competition in China. The downgraded valuations in the solar-energy market may suggest more Chapter 11 filings to come in the near future.

Ward: As in any economic crises, the retail industry continues to struggle. With the US unemployment rate maintaining historical lows, consumer spending is obviously struggling as well. This lack of consumer confidence hits the retail sector first. In addition, other sectors that cover discretional spending are having problems too. We have also seen the recreational vehicle market and vacation clubs struck by the consumer struggles. Finally, emerging technologies coupled with lack of consumer spending have affected older, more established enterprises. Borders is the perfect example of this.

The wild card may be if the credit markets tighten as a result of continued volatility and companies can no longer refinance debt. If this occurs, the upsurge of Chapter 11 filings could materialise sooner than anticipated.

JONATHAN A. CARSON

Goffman: The capital markets volatility seems to be sparing no one. That said, media (particularly in connection with newsprint), lumber and related industries (due to slowness in home building) and the home building industry itself, along with retailers (due to a reduction in consumer confidence), are all experiencing some level of distress. I continue to expect that this distress will continue to impact the commercial real estate market also. Hospitality has also shown signs of slowness, although there are pockets of healthy hospitality companies, as more businesses are putting their executives on the road.

Chatz: The retail, real estate development, and auto supply sectors are those with the most pronounced structural weakness right now. Retail sales, whether by national chains or single store boutiques, are weak because consumers continue to show reluctance to increase their spending. The expenses for these businesses continue to rise, and profits, to the extent they exist at all, are squeezed. Real estate development is very sluggish, and will remain so until the supply of housing drops to levels which necessitate more buying. Even the survivors in that industry are having issues. The auto supply sector is weak due to consumers' reluctance to purchase big ticket items like automobiles and the large manufacturers' pricing power in a stagnant marketplace.

Berman: We have seen continued stock market volatility and S&P's downgrading of the US long-term sovereign credit rating. In your opinion, what knock-on effect might such developments have on corporate bankruptcy in the near term?

Sprayregen: This is a very murky area. The real answer depends on what happens with several major issues during the balance of the year and in 2012, particularly the US economy, sovereign debt issues in Europe, and related bank capital issues. So far, we have seen a limited immediate effect. There have been a number of high yield bond offerings that have been pulled, but it is unclear whether the capital markets were closed because of summer vacations or a more secular issue. We should find out the answer to that soon.

Carson: Conventional wisdom says that there's a cause and effect relationship between stock market volatility and the immediate increase in the number of Chapter 11 case filings. In reality, the tightening of the US economy triggers large companies to spend less and reduce expenses to wade through market uncertainty. With current interest rates remaining at record lows for much longer than expected, companies not only have access to capital, but also reap the benefits of low-cost borrowing. The one-year LIBOR rate lingers at less than 1 percent which enables companies to economically amend their debt contracts in the short term and extend the need to file bankruptcy. The wild card may be if the credit markets tighten as a result of continued volatility and companies can no longer refinance debt. If this occurs, the upsurge of Chapter 11 filings could materialise sooner than anticipated.

Ward: The fact that the US credit rating can be downgraded solidifies the fact that any struggling US company can be downgraded at a moment's notice. In the past, a company may have been willing to take a 'wait and see' approach with its struggles. However, given the threat of downgrade, an underperforming company may be more aggressive to restructure its business to prove to the market that it has straightened the ship. The long term effect of this scenario is yet to be seen, but I think we will see more companies taking a proactive approach to restructure, not necessarily reorganise, their business to impress market forces.

Goffman: Market volatility does not kill transactions among fundamentally healthy companies. It does crater transactions where either acquirer or target is dependent upon a particular stock price or capital markets outcome. In the near term we expect smaller public companies on the bubble to experience real challenges as a result of the tumult currently going on in the markets. The downside of the US long-term sovereign credit rating is most likely to affect the psyche and confidence of the US consumer, which, in turn, may continue to negatively impact those industries dependent upon the consumer.

Chatz: All businesses which rely on bank debt are struggling with the decrease in the availability of funds from traditional lenders, particularly in the middle market sector. If for some reason S&P's actions cause an environment of increased interest rates, this could negatively impact corporate enterprise and lead to increased costs which may not be economically palatable.

Perkins: I think the jury is still out with respect to the direct causal effect of the downgrade. It may cause some things to trigger in the various debt instruments that could increase borrowing costs. The larger impact, though, is on the impact it has had on the national psyche, especially the political process that led up to the downgrade. Regardless of party, the gridlock was screaming in the face of the American public. Consumers recognise that that is not an efficient way to manage a crisis, and that lack of leadership makes people scared. Scared people do not feel confident in their job, home, or life, and do not go out and spend money to increase corporate revenues – not that they should anyway. Given that consumers make up nearly 70 percent of our GDP, the consumer needs to be confident so they will spend money to pull us out of the ditch.

Berman: Reports suggest that between 2012 and 2015 a huge volume of leveraged debt is set to mature, forcing struggling companies to restructure their balance sheets during a slow economic recovery. What do you anticipate will be the impact of this scenario in the years ahead?

Carson: In 2010, corporate bond issuance reached an all-time high of more than $1 trillion, $263bn in high-yield issuance, alone. Through 31 July 2011, corporate bond issuance continues to swell with over $691bn, in which high-yield debt accounts for $180bn. Simply stated, the debt-maturity threat is far from over. While the can has been kicked down the road, more than $900bn in debt has been postponed to mature in 2015 and beyond. Depending on how the credit markets perform over the next few years, we could see a spike in Chapter 11 filings.

The downside of the US long-term sovereign credit rating is most likely to affect the psyche and confidence of the US consumer, which, in turn, may continue to negatively impact those industries dependent upon the consumer.

JAY GOFFMAN

Ward: From my experience, the number one cause of US bankruptcy filings is being unable to restructure a leveraged debt that is set to mature. I believe you will see numerous companies trying to restructure their business over the next 12-18 months in order to streamline their affairs to make more cash available to pay down existing obligations and restructure the remainder of those obligations that will be paid by a leaner, better positioned company. This is a daunting task and takes the cooperation of a willing lender to do so. A lender that may be interested in owning the company may choose to use this upcoming maturity as an opportunity to put pressure on the company with the sole purpose of eventually owning the company after maturity passes and the company is left with no option but to file for bankruptcy to stave off the lender while they negotiate an amicable loan-to-own scenario.

Goffman: We have all witnessed the so-called 'wall of debt' quietly move back from the early part of the decade into later years. It is hard to predict whether or not it will continue its slow shift into the future, but I do believe that this period of stagnation or slower economic growth will have a negative impact on the ability of certain companies with substantial debt loads to restructure their obligations. I also believe that many companies that were healthy enough to refinance, did so – in advance of their debt maturities – over the last year or so, taking advantage of the open credit markets. Some companies that did not do so will have a more difficult time if credit is not as available over the next few years.

Chatz: The impact of maturities relating to indebtedness may be material. The general lack of credit availability and the unwillingness of lenders to refinance or extend existing loans threaten businesses in a wide swath of industries. It is not clear if, when debt obligations become due, reorganisation will be an alternative for these companies. There may not be available credit, whether through debtor in possession financing or exit financing to support reorganisations in or outside of a federal bankruptcy process. This will only lead to more liquidations and asset sales.

Perkins: The obvious impact is that there will be substantially more defaults, as revenues and cash flow targets have not recovered to the levels expected when the loans were originated. That said, the real question is how the banks and lenders will react. Through 2010 and 2011, many businesses took advantage of the 'amend and extend' option. My question is whether the banks will support that option again. That answer may come down to the bank regulators. My opinion is that many of these deals should be worked out and restructured to get to a sustainable, healthy level. I think fixing the problem once-and-for-all is a better option than kicking the can down the road.

Sprayregen: It all depends on whether the capital markets reopen, stay open, and are robust, or not. In the commercial mortgage backed securities area, it also may depend on valuations. Even if the CMBS market were to reopen, many of the deals may not be able to be refinanced at par and thus the refinancing may need to be done as part of a below-par restructuring; however, the next major wave of CMBS maturities is not until 2015/2016. To the extent the capital markets remain robust, there can be sufficient capacity and liquidity in the capital markets to avoid a major restructuring boom. However, to the extent the capital markets do not remain wide open, many restructurings will likely occur.

Berman: To what extent have you seen fewer, as well as shorter, Chapter 11 reorganisations? Can this be attributed largely to the appetite for prepackaged and prearranged Chapter 11s?

Ward: There have clearly been fewer Chapter 11 bankruptcy filings, and the filings that we are seeing have a very short shelf life. I think this is partly attributable to the prepackaged/prearranged phenomenon. I think it is also partly due to quick 363 bankruptcy sales that have become the latest fad. However, I think it is mostly due to the cost of taking a company through Chapter 11. The cost of a long, drawn out Chapter 11 bankruptcy gave rise to the concept of negotiating the bankruptcy plan prior to filing and only using the Bankruptcy Court to implement and confirm that plan. The concomitant costs of being in bankruptcy, in addition to the professional fees incurred in bankruptcy, make this a very palatable option.

Chapter 11 is a very expensive, complicated process. Banks are requiring expedited outcomes in order to reduce the administrative expense costs of the professionals in the bankruptcy. Prepackaged and prearranged bankruptcies help to mitigate these costs, assuming that litigation does not ensue.

BARRY A. CHATZ

Goffman: I have always been a proponent of prepackaged and prearranged Chapter 11s. I devised the concept for prepacks in the late 1980s and have been a strong advocate for prepacks for over 20 years. In the US, over the past 30 years, restructuring professionals and distressed investors have learned that a successful restructuring ordinarily should be a quick business transaction, not a multi-year litigation process. The company does better and all stakeholders generally do better not wasting resources on long, drawn out Chapter 11 cases. Prepacks combine the best elements of out of court restructurings – the ability to negotiate a balance sheet deleveraging without the costs, stigma, and uncertainties associated with Chapter 11 – with the binding powers of Chapter 11.

Chatz: Chapter 11 is a very expensive, complicated process. Banks are requiring expedited outcomes in order to reduce the administrative expense costs of the professionals in the bankruptcy. Prepackaged and prearranged bankruptcies help to mitigate these costs, assuming that litigation does not ensue. The Bankruptcy Courts are also pushing debtors not to stay 'parked' in their courtrooms for an extended period of time, and are setting firm, short dates for plans of reorganisation and disclosure statements to be filed. The expense of the Chapter 11 process often leads to different choices being made by debtors and their creditors which, sadly, includes liquidation. The transaction cost for a Chapter 11 may not be feasible given a number of factors including debt levels, business size and/or future viability.

Perkins: I think the overall volume of bankruptcy is down from the prior two years due to the large bubble of bad deals that were on balance sheets heading into this crisis. The easy credit decade allowed many companies to survive that would not have in prior cycles. The shorter duration of Chapter 11 is definitely related to the prearranged bankruptcies. With the level of sophistication now involved in the financial markets, bankruptcy is often primarily a vehicle to transfer assets between various owners/lenders. Being in bankruptcy for long periods of time is bad for long term values. With that in mind, companies, counsel and advisers have learned that knowing how to get out of bankruptcy is a critical question that needs to be answered prior to filing.

Sprayregen: I have seen fewer Chapter 11 reorganisations in 2011 than between 2008 and 2010. Of the ones that have occurred, many have been shorter and of the prearranged and prepackaged variety. However, some have been straight Section 363 sales, which also go very quickly, but are in the main going concern liquidations. The length of time of these bankruptcies is not always driven by prepackaged or prearranged, but may be driven by unavailability of DIP financing to provide the 'powder' for a lengthy full Chapter 11 process. Many hedge funds also do not care for a lengthy, full Chapter 11 process and would prefer an early exit, even without a full fix of the company, as it may permit monetisation of their position on a more accelerated basis.

Carson: The number of large public company Chapter 11 filings has fallen over the last few years. According to Bankrutpcydata.

com, in 2009, 210 public companies filed for Chapter 11 compared to 106 public company filings in 2010, and there are 53 filings as of 1 September 2011. While prepackaged and prearranged bankruptcies can serve as valuable strategies to help cleanse balance sheets, the improved credit markets, low interest rates and the 'amend and extend' phenomenon are the contributors to the decrease in Chapter 11 filings. Prepackaged and prearranged bankruptcies account for 14 percent of the overall public company Chapter 11 filings from 1 January 2009 through 1 September 2011.

Berman: Has there been a continued increase in Section 363 sales under the US Bankruptcy Code? What advantages does this process offer to distressed debtors and their creditors?

Goffman: Section 363 sales continue to play a vital role in the distressed arena. For example, there are times when a distressed company simply doesn't have a homogenous group of constituents that would enable a prepackaged or prearranged Chapter 11 case. At the same time, if the company has a wasting asset or there is some other urgency compelling a speedy transaction to preserve going concern value, Section 363 may be the best available tool to maximise recoveries. A perfect example of this was the acquisition of AmericanWest Bank through the Section 363 sale of the stock of the bank, held by its parent, a Chapter 11 debtor. The need for a quick transaction was urgent, due to the fact that there was a substantial risk that the FDIC would put the bank into receivership. Section 363 allowed the company to conclude a transaction quickly, with the securities holders being bound by the resulting court order.

Chatz: Recent case law has chipped away at the absolute certitude of a 363 sale, particularly absent assurance that the seller provides notice to all potential governmental units that may have claims against the debtor's estate. The need to assure proper notice to true and potential claimants, particularly when there are possible issues of environmental liability, unpaid wage based claims and potential other springing charges by state and local governments require significant diligence by those professionals handling these matters in order to assure client protection and the efficacy of an order that claims the sale is free and clear. There has not been a particular increase in the number of cases filed or the number of 363 sales pursued as to this date, it does not appear that secured lenders are rapidly requiring a sale process to maximise recoveries in the near term.

Perkins: There is definitely an increase in the use of Section 363 in the bankruptcy process. Given that bankruptcy is often used as a tool to convey assets, 363 appears to be the specific tool of choice to get the job done. The obvious advantage of the process is that buyers can acquire assets free and clear of liabilities from prior management, even with the current heightened attention related to noticing and process. They can often find things at deeply distressed prices that need some TLC. I think sophisticated buyers have made many fortunes in that business. The lack of DIP financing for long-duration cases has pushed towards faster resolutions, which often result in 363 sales. For creditors, the advantages are that there is a fair, market-driven, and relatively fast auction process to maximise value of the assets under the supervision of the US Bankruptcy Court.

There is definitely an increase in the use of Section 363 in the bankruptcy process. Given that bankruptcy is often used as a tool to convey assets, 363 appears to be the specific tool of choice to get the job done.

LAWRENCE R. PERKINS

Sprayregen: During 2008-2010 there was a marked increase in Section 363 sales. This largely occurred because of the lack of availability of DIP financing to finance a lengthy, full-bore Chapter 11 process. As the capital markets have loosened up, there have been more DIPs available, although that market still has not completely reopened from the pre-Lehman days. The main advantage of this process to debtors and creditors is speed. I, however, am not convinced that speed always produces the most value. There are costs and benefits to that speed. Sometimes the costs are that the restructuring is more of the funded debt than of the operations of the entity, and the true problems are not dealt with.

Carson: Debtors and their creditors have increasingly utilised Section 363 asset sales to fast track the Chapter 11 process or increase their returns. Since 2004, more than 20 percent of large public company bankruptcies engaged in Section 363 sales of all or substantially all assets. With a Bankruptcy Court's approval, buyers can transfer assets free and clear of liens, fend off claims by shareholders and creditors and acquire assets without taking on liabilities that might come through traditional M&A transactions. For debtors and their creditors, Section 363 sales can be utilised to preserve the value of the core business, remove underperforming or non-strategic business units from the company's balance sheet and generate operating cash flow.

Ward: The Section 363 bankruptcy sale is to our era what the M&A transaction was during the Wall Street boom. Sophisticated investors have realised that the Bankruptcy Code gives buyers many more options to fix a company as part of a sale than your traditional M&A deal. Section 363 allows a buyer to reject unwanted contracts and leases, assume and assign certain contracts and leases in a manner that could not be accomplished outside of bankruptcy and provides leverage over certain vendors and service providers that the company would not have in a traditional sale. These advantages can only be found in a 363 sale. In addition, the Bankruptcy Code requires an open and fair sales process. A struggling company not fortunate enough to have a white knight suitor in place can utilise the 363 sales process to market its assets and potentially attract investors that would not consider a transaction outside of the bankruptcy context.

Berman: Are you seeing more debtors in Chapter 11 use rights offerings to restructure their balance sheet and raise exit capital? What benefits can be gained from a rights offering in this context?

Chatz: The answer to this question is generally no. Chapter 11 filings with debt restructurings utilising its offerings are the exception rather than the rule. The potential tsunami relating to the huge volume of leveraged debt coming due over the next period of years may lead to utilisation of rights offerings or other creative mechanisms to restructure balance sheets.

Perkins: I have not witnessed rights offerings as much in the middle-market deals that we tend to focus on. The appeal for us of many middle-market cases is that they typically have fundamental business problems that require fundamental business solutions. The use of rights offerings is certainly an interesting trend to watch in bankruptcy now, but I think it will take some time to matriculate through to the middle-market due to the challenge of valuing securities in these smaller, lesser known and generally more volatile companies.

Sprayregen: Since around 2005, rights offerings have markedly increased in usage. They are excellent vehicles for creditors to 'put their money where their mouth is'. There are many nuances and different kinds of rights offerings, some providing greater advantages to those willing to underwrite the rights offering, and some providing wide-open participation rights for virtually all creditors. Depending upon their structure, there can be greater benefits for the underwriter, along with greater certainty for the debtor. However, there are many creditors who, either structurally or financially, cannot participate in rights offerings, and, thus, the restructuring community needs to be careful that these vehicles are used fairly.

Carson: As a result of tight credit markets during the financial crisis, we saw an increase in the use of rights offerings. For debtors, a rights offering provided financing that was not available through traditional channels for exiting bankruptcy or restructuring balance sheets. In addition, by controlling who can participate in a rights offering, debtors play a major role in determining the future owners of the company to strategically influence future operations. Rights offerings have demonstrated to be a beneficial strategic option in the corporate-restructuring process and will continue to be utilised by professionals as they become more familiar with the mechanics and the procedures involved in rights offerings.

Since around 2005, rights offerings have markedly increased in usage. They are excellent vehicles for creditors to 'put their money where their mouth is'.

JAMES H.M. SPRAYREGEN

Ward: Given the state of the global economy, I have not seen an influx of rights offering in bankruptcies in recent months. However, similar to the 363 sales process, using a bankruptcy case to issue a rights offering provides the same benefits. Certain contracts and leases that may deter a potential investor from participating in a capital infusion can be altered or eliminated in bankruptcy, which would allow for a more profitable company to emerge from the bankruptcy process and thus make a rights offering appear more attractive in bankruptcy.

Goffman: In recent years, we have definitely seen a rise in the use of rights offerings as a restructuring tool. The key advantage of such an approach is that it not only enables a company to raise needed funds, but it also allows existing creditors and equity security holders to each make their own decision as to whether they want to increase their investment in the debtor or not. For example, multiple classes of debt and equity can be invited to participate in the rights offering, with each individual debt and equity holder making their own investment decision as to whether to participate in the new investment. This approach satisfies the Bankruptcy Code requirement that all members of a class have the same treatment and opportunity, but it also allows individual decision-making.

Berman: In terms of bankruptcy related litigation, what are the common types of disputes dominating today's bankruptcy proceedings? Does this added conflict often undermine the chances of achieving a successful restructuring?

Perkins: In our firm's middle-market world, the two types of litigation I've seen most are 'busted deal' litigation, and alleged fraud litigation. The busted deals fall into several categories, but they usually relate to a fund or company investing time and resources in trying to close a deal, and ultimately having it fall apart largely because of the confusing valuation environment we find ourselves in, as well as the volatility of the credit markets and the inability to find adequate leverage. I have also noticed a disturbing trend in the increased incidence of bad behaviour by certain stakeholders in companies. Issues ranging from stock fraud, borrowing base shenanigans, outright theft, or other things appear to be much higher now than in earlier cycles of my career. It could just be that the low tide has exposed more rocks.

Sprayregen: The biggest development in bankruptcy related litigation is the Stern case decided recently by the US Supreme Court, finding unconstitutional a portion of the 1984 jurisdictional grant that Congress provided to the Bankruptcy Court. This decision has sown massive procedural confusion into the system. It will take many years, and many more decisions, likely from the ►►

Circuit Court of Appeals, and probably the US Supreme Court again, to clarify how the bankruptcy litigation system works on a procedural basis and what matters can be heard before bankruptcy judges on a final basis and what matters need to be heard by District Court Judges. There is massive opportunity for procedural machinations at this point in the process. This can undermine the chances of achieving a successful restructuring. However, the very confusion sown by this decision may also incentivise stakeholders to settle various issues to avoid this confusion.

Carson: We continue to see a variety of disputes arise throughout the bankruptcy process including disputes about cash collateral motions, the terms of debtor-in-possession financing, valuation disputes and preference actions. In addition, there has been an increase in securities litigation in bankruptcy scenarios as well as an uptick in fraudulent transfer claims. As a result, companies that enter into Chapter 11 face more conflict and opposition throughout the process even if the restructuring is prearranged and can often end in a liquidation scenario or asset sale.

Ward: Litigation, both in and out of bankruptcy, remains strong. The most common type of bankruptcy litigation in recent times is the preference action – where the bankruptcy estate is seeking to recover any payments it made to creditors within 90 days of the bankruptcy filing. While preference actions are by far the most commonly filed actions, we are seeing more fraudulent transfer and actions against D&O and/or E&O policies. In addition, creditors are now faced with liquidating bankruptcy plans that wholly contemplate proceeds of litigations as the sole source of recovery for creditors. There are many benefits and pitfalls to these plans. The obvious benefit is a potential meaningful distribution to creditors. The pitfalls include frivolous causes of action trying to extort quick settlements with creditors or insurance carriers.

Goffman: If I had to identify the two areas in which we see the most litigation that negatively impacts the ability to reorganise a company, I would say that they arise in the valuation and/or priority of lien area. Specifically, by valuation, I mean where various parties – such as holders of bank debt, bonds and equity securities – disagree as to the value of the company to be reorganised. What is at stake in these valuation disputes is control of the reorganised company. For instance, if there is no value for equity, then the junior-most level of unsecured debt will likely control the company upon emergence. Likewise, if there is no value for unsecured creditors, then it is likely that secured holders of bank debt or bonds will control the company.

Chatz: The reality today is that many, if not most, bankruptcy cases create some litigation. Creditors have been fighting over lien rights over asset pools which are substantially smaller than they have been historically. Preference and fraudulent conveyance litigation will continue to be pursued under sections of the Bankruptcy Act. The issue of solvency at the time of debtor's transfers has been, and will continue to be, hotly litigated by defendants seeking to fend off exposure to claims by debtors and/or other parties cloaked with the responsibility of collecting the maximum recovery for the benefit of all creditors. All of this has been augmented by bankruptcy judges' willingness to set trial dates on contested issues, which often forces the parties to litigate in a shorter timeframe.

Berman: Would you say directors and officers in the US are now more susceptible to class actions being brought against them following a bankruptcy event? How can they protect themselves from such situations?

Sprayregen: The development of the law related to the potential liability of directors and officers in the US for companies that restructure or file for bankruptcy actually has improved over the last several years. The Delaware Supreme Court has issued several clarifying decisions related to director and officer liability, virtually all of which can be considered director and officer favourable. Directors and officers can best protect themselves from liability by obtaining professional advice as to their rights, responsibilities, alternatives, and proper process early and often.

Ward: Directors and officers are as vulnerable as ever in this new age of bankruptcy and post-bankruptcy litigation. Full releases for a debtors' officers and directors are harder than ever to achieve. Since neither the company nor its directors and officers gets a discharge in bankruptcy, disgruntled creditors that are frustrated with the bankruptcy outcome are frequently going after the D&Os via post-bankruptcy litigation. The best way for the directors and officers to protect themselves from this after-the-fact attack is to seek a full release in the bankruptcy plan. Although difficult to achieve, they are still attainable in jurisdictions like Delaware. However, something more than 'sweat equity' is typically required. An infusion of capital or other noteworthy investment is usually needed to obtain a full release. While this may not seem like a worthwhile decision at the time of a plan, the cost of doing so is less than the cost of facing an impending D&O action that seeks to tag the directors and officers personally.

Goffman: I do not think that directors and officers are any more exposed to derivative actions following a bankruptcy. That said, I continue to believe that the best defence for directors remains a good offence – namely, getting early and expert advice from professionals whose experience bears directly on the challenges directors and officers face. For example, if a company needs capital, a board is best served by hiring a quality investment banker to assist with that effort. If the company is facing a complicated balance sheet restructuring, in addition to financial expertise, the board would be wise to engage sophisticated counsel who has been involved in similar previous transactions. If the Chapter 11 process is properly handled, officers and directors often receive releases under the plan.

Chatz: Directors and officers of companies in Chapter 11 should be assured prior to the filing of any bankruptcy that there are sufficient funds to provide for their advocacy and defence within the bankruptcy process. Counsel should fully participate for the benefit of directors and officers throughout the process and negotiate terms within a plan of reorganisation that will prevent post-confirmation actions if possible. Also, directors and officers should make sure that there is sufficient insurance coverage to, at a minimum, provide them with a defence of any actions commenced. Those foolish enough to believe that debtors counsel will be in a position to provide them with independent protection are naïve. An individual who will serve on the board of any entity, let alone a distressed entity, must be comfortable that he has sufficient insurance and competent counsel who understands both the bankruptcy process and the unique issues surrounding protection of officers and directors.

Perkins: I do not believe that US directors and officers are ultimately any more susceptible to class actions than they have been in the last decade or so. I think the information age in the post SOX world has contributed to more director and officer scrutiny than the recent crisis. The best advice to protect themselves is quite simple: do your job. A second piece of advice would be 'have competent counsel, and listen to them'. As a board member of several organisations, I take the fiduciary responsibilities mandate very seriously. I think all directors should spend more time learning what this truly means. If they did, they might know better when they are over their head and when they should reach out to the outside world for advice, particularly in the zone of insolvency, when corporate governance and action must take a decidedly different path.

Berman: Companies that do manage to emerge from Chapter 11 are at risk of succumbing to a second economic dip and entering a 'Chapter 22' scenario. Do you expect to see a rise in this trend going forward? What steps can vulnerable companies take to avoid 'Chapter 22'?

Carson: There are various types of conditions that can lead a company to enter into Chapter 11 from a decrease in consumer spending, to weak economic conditions, or tight credit markets. As a result, a company's management team looks to the corporate restructuring process to manage balance sheet issues, yet can find themselves not right-sizing operations appropriately. Since 2009, companies that entered into Chapter 22 criticised reduced timeframes in Chapter 11 that didn't provide adequate time to fully address the issues that plagued the business. To avoid Chapter 22, companies that have emerged from Chapter 11 should keep financial records and contracts organised, keep to the tenets of the plan of reorganisation by adhering to operational efficiencies and remain accessible to creditors.

Goffman: There has been a lot of ink spilled on the so-called phenomenon of 'Chapter 22'. In my experience, a second Chapter 11 case often has little or nothing to do with the causes of the original Chapter 11. For example, US Airways was the subject of multiple Chapter 11s. The second Chapter 11 was brought on primarily as a result of unprecedented fuel prices as well as intense and unexpected competition from Southwest, rather than the outcome of its prior Chapter 11. You tend to see 'Chapter 22's' in highly competitive and volatile industries. The multiple Chapter 11 phenomenon is a reflection of that fact rather than the Chapter 11 process. In my view, it is often the case that the negotiating constituencies in a Chapter 11 will elect to distribute value with the expectation that if things do not go precisely as the parties predict, there will be winners and losers. Those winners and losers are determined by negotiating leverage and priority in the existing capital structure based on a sophisticated understanding and discussion of the issues. It is hard to be critical of that kind of approach, especially when you consider that the alternative may be liquidation.

Chatz: True Chapter 11 reorganisations leading to post-confirmation operation are few and far between, and have been since long before the current economic downturn. Most cases currently are filed for operating companies to utilise Chapter 11 for a 363 sale process. Those entities that did 'reorganise' are often forced into another filing because many of the same structural issues which plagued the company prior to the first filing persist. This is not helped by the stagnant sales environment caused by the continued high unemployment and the lack of buying power of those employed consumers in the market place.

Perkins: I do think there will be a trend towards more Chapter 22s. I think that some of the restructurings and deals that took place in the early stage of this crisis were put together thinking that the economic recovery, and ultimately revenue levels, would return to pre-crisis levels more quickly. There was much talk at early stages of the recession of a 'v-shaped' recovery. We've since learned that this recovery is much flatter, and has been obviously quite bumpy along the way. Basically, if the restructuring was tied to what turns out to be an aggressive forecast, there is real risk that a Chapter 22 may happen. I think that the riskiest class are the restructured entities that were not folded into, or bought by another firm. If firms kept operating businesses the same way, did not focus on the operating turnaround by eliminating the most problematic parts of their operations, and were hoping for stronger economic recovery, then they may be in for some very tough medicine.

Sprayregen: More Chapter 22s may well be on the horizon. One consequence of the faster Chapter 11s we have seen over the past couple years through the use of various prearranged and prepackaged plans, is that those kinds of restructurings often result in sub-optimal balance sheets at exit, where not enough debt is taken off the balance sheet and/or operational problems are not dealt with because they would slow down the prearranged or prepackaged case, and the company limps out of the bankruptcy process. That is mostly done on an 'eyes wide open' basis, but the consequence is that companies are more exposed to a downturn in the marketplace that may push them back into another restructuring. When more bankruptcies were 'free-fall' Chapter 11 cases and underwent full reorganisation processes where many of the 'tools in the tool box' of Chapter 11 were employed, it did result in much longer bankruptcies and more expensive bankruptcies professional-fee wise, but also resulted in a more comprehensive fix of the company such that, post-exit, the company had a lower risk of a Chapter 22.

Ward: The companies at risk of the Chapter 22 experiences are companies that were subject to the loan-to-own suitors. I have seen several loan-to-own scenarios where the secured lender that is seeking to acquire the assets does not use the bankruptcy process to its fullest potential. Putting the pace of the bankruptcy ahead of the ultimate outcome, these lenders do not use the bankruptcy process to reject cumbersome contracts and leases, to renegotiate burdensome deals or otherwise restructure the business. Instead the bankruptcy process is used to write off the secure debt, reduce or even eliminate the unsecured debt and put themselves into the company's equity structure. More focus on the benefits of the deal may have put them in the same equity position but they would be taking on a much leaner and healthier company. ■