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ROUNDTABLE

Bankruptcy in the Americas

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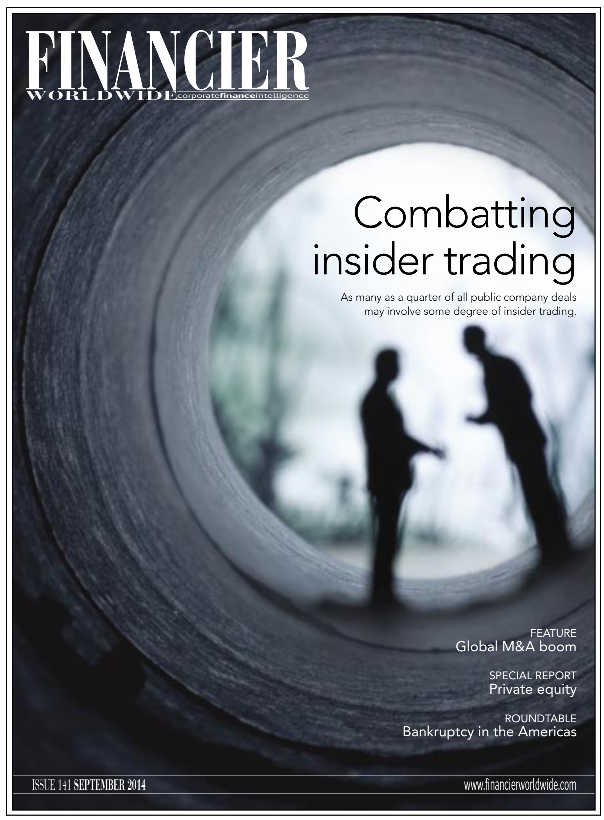

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ROUNDTABLE

BANKRUPTCY IN THE AMERICAS

The US restructuring industry continues to experience historically low Chapter 11 filings, driven by access to capital markets and an abundance of liquidity at attractive interest rates. However, that picture is not consistent across the Americas. The last 12 months have seen a spike in Mexican restructurings and, as a consequence of amendments to the country's bankruptcy laws, the number of bankruptcy filings may increase going forward.

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Shaw: How would you describe the level of corporate bankruptcies in your region over the last 12-18 months? What factors are shaping this trend?

MacParland: The past 12 to 18 months have been less active than we typically experience. Bankruptcies are definitely down. Corporate arrangements, which are more surgical, and refinancings are more common.

Kass: The US restructuring industry continues to experience record low Chapter 11 filings. According to New Generation Research, Inc. there were 33 public company Chapter 11 filings as of the end of July 2014 compared to 49 during the same time last year. In this low interest rate environment, potential debtors are able to access capital through the term loan and high-yield bond markets to refinance existing debt alleviating liquidity pressures. According to *Standard & Poor's LCD*, US high yield bond issuance through July 2014 was at $205bn, up from $192bn during the same period in 2013. We continue to see investors take on riskier positions with fewer covenants in search of higher returns. A combination of access to liquidity and robust investor appetite provides troubled companies with time to negotiate an out-of-court restructuring, avoiding a bankruptcy filing in the immediate future.

Dorsey: Levels are tepid, consistent with national trends. Business failures resulting from the 2008-09 financial collapse have substantially run their course. New cases are slow to develop because corporations have generally been risk averse since 2008, conserving cash and limiting plans for expansion and growth, while lenders, under regulatory and governance pressures, have been equally conservative in financing, with much of the lender activity through 2013 focused on refinancing existing borrowers. While these conservative dynamics have been changing over the last year, new business bankruptcy cases likely remain on the distant horizon, with the exception of certain areas like healthcare and municipalities. The stagnation in business bankruptcies is also caused by low interest rates, which buffer businesses from potential filings, and an increase in liquidity as financial institutions now feel a greater need to deploy funds more broadly. Finally, the lack of middle market merger and acquisition activity, and the lack of business expansion, has left many companies, private equity groups, and hedge funds with unprecedented levels of cash. This has created the opportunity and incentive for these investors to buy distressed loans in a 'loan to own' strategy, which has given traditional lenders a quicker exit path, leading to fewer long term workout and restructuring situations.

Durrer: While some commentators, such as Bloomberg, report that corporate bankruptcies are significantly more frequent, at some 40 percent, so far than during the comparable period in 2013, the marketplace feels about the same as last year. Relevant factors driving this anecdotal analysis are twofold. First, rescue capital is still very much available, allowing companies in distress to avoid a more substantial day of reckoning. Second, those companies that do file Chapter 11 are typically pursuing prepackaged balance sheet restructures or prompt sales of assets such that the companies do not linger in Chapter 11. The short duration of such cases contributes to the 'feeling' that there are fewer filings.

Espejel: Latest research by the Federal Institute of Commercial Bankruptcy Specialists (IFECOM) indicates that corporate bankruptcies are concentrated in the major cities of Mexico, mainly in Mexico City. As a consequence of the legal amendments to Mexico's Commercial Bankruptcy Law – *Ley de Concursos Mercantiles* (LCM), in effect since January 2014 – it is expected that the number of bankruptcy filings will increase in the coming months and years, inasmuch as the changes to the LCM aim to establish a true balance between the debtor and its creditors, as well as to expedite the bankruptcy proceedings in order to maximise the value of the bankruptcy estate for the benefit of all the stakeholders. The foregoing objectives are considered as achievable by entrepreneurs and creditors, considering that the legal reform implies a material reduction on the risk of delayed proceedings and uncertainty as to the application of the law. Minimising these risks will result in the benefit of creditor's rights, which, as a consequence, will increase the access to loans and credits in better financial conditions.

Alfonso: We have not seen an uptick in corporate bankruptcy filings in the US, which have been slow for the past two years or so. Struggling companies have continued to avoid bankruptcy because of the borrower-friendly lending atmosphere and the robust M&A environment. Even overleveraged companies in the most vulnerable industries have managed to raise capital and amend their existing debt documents to extend their runways. Companies in general are taking advantage of the loan markets to refinance their debt on favourable terms. Several of the major bankruptcy cases filed over the last 18 months have been driven by particular factors that augur for a bankruptcy process, such as the desire to implement a quick asset sale with Bankruptcy Code protections for the buyer, or the desire to implement a restructuring that cannot be accomplished out of court because of holdouts or incalcitrant parties in interest.

Golubow: The number of corporate bankruptcy filings in the United States has continued to decline over the past 12 to 18 months, prolonging a trend that stretches back to the financial crisis of 2008-09. In fact, we haven't seen numbers at such low levels since 2006. This downward trend can be attributed primarily to the interaction of two phenomena. First, the US Federal Reserve continues to maintain a policy of historically low interest rates, thereby providing inexpensive financing accessible to many companies. Second, bankruptcy is considered the option of last resort as the process is very expensive due primarily to substantial professional fees incurred by all parties-in-interest. Thus, lenders have been more receptive to extending debt maturities. These two factors have joined together to form a perfect storm of sorts, encouraging distressed businesses to avoid a bankruptcy filing while allowing them to refinance existing debt.

Shaw: Which sectors seem to be experiencing fundamental structural weaknesses at present?

Kass: We continue to see some industry sectors face headwinds due to legislative activity, technological advancement and consumer behaviour. The healthcare industry has been impacted by recent legislative activities resulting in payer system changes. These changes may have unforeseen implications that could have a long term impact on companies operating in this space. Companies in declining industries such as paper and print are struggling with the move to technological efficiencies such as digital. Changes in consumer behaviour continue to impact ▸▸

brick-and-mortar retailers and we are seeing large retailers struggle to achieve growth in same store sales without significant capital expenditures and store upgrades.

Dorsey: The healthcare industry is in the early stages of dramatic change as members respond to the dual mandates of increased coverage of the population and cost containment. These forces may lead to an increase in distressed merger and acquisition transactions with strong providers making strategic acquisitions and weaker providers searching for suitors and structures which will allow them to continue to serve communities and escape growing financial pressures. The change in this industry will also be exacerbated by high levels of legacy debt that will mature in the near term while revenues are dropping and refinancing is difficult. The retail sector also has some vulnerability as the balance between retail operations and internet sales continues to evolve. Municipalities, counties and other governmental authorities with their substantial legacy debts continue to walk a financial tightrope as they watch the outcome of the Detroit bankruptcy and measure their options.

Durrer: Utilities, such as Energy Future Holdings Corp., and industrials, like the series of shippers followed most recently by Eagle Bulk Shipping Inc., are among the sectors most represented among Chapter 11 filings in 2014. It is not entirely clear whether such sectors suffer from 'fundamental structural weakness', although many would agree that the shipping industry remains in distress. We also see continuing weakness among retail, real estate, in particular large malls, and healthcare as the effects of Obamacare continue to play out.

Alfonso: The energy sector, especially the coal industry, continues to confront weak demand, high environmental and regulatory compliance costs, and unionised labour costs in some cases. Other regulated industries such as media, telecommunications, healthcare and financial services continue to confront challenges right now.

Golubow: Despite reports that the US economy is growing at a 'solid rate', several industries present signs of structural weakness due to technological changes that made their traditional products or services obsolete, while others have been weighed down by increased regulation or a shift in consumer preferences. Among them are healthcare and in particular nursing care facilities, specialty retail industries and casual dining restaurants. Large brick-and-mortar 'big box' retailers are vulnerable and losing the battle against online retailers as consumers find that the items they seek are less expensive and more easily accessible online. The nursing care facilities industry has been hindered by decreasing government support for Medicare and Medicaid, which account for a substantial portion of the industry's annual revenue. In the wake of the increase in federal minimum wage prices and the need to comply with the Affordable Care Act, the casual dining sector is likely to suffer as operating costs increase across the board and consumers resist increased food prices.

Despite reports that the US economy is growing at a 'solid rate', several industries present signs of structural weakness due to technological changes that made their traditional products or services obsolete, while others have been weighed down by increased regulation or a shift in consumer preferences.

RICHARD H. GOLUBOW

MacParland: Most recent activity is in the resource sector. There has been significant activity in the retail and construction sectors. Manufacturing continues its long, slow decline.

Shaw: Could you highlight any recent legislative or regulatory developments, including high profile cases, that will have a significant effect on bankruptcy and restructuring in your region?

Dorsey: The Patient Protection & Affordable Care Act is still in the process of implementation and will have a significant impact on both healthcare providers and businesses. *Stern v. Marshall* and its progeny continue to create uncertainty regarding the power of the bankruptcy courts to issue final judgments, creating fertile ground for argument and potentially causing substantial delay and expense in administering bankruptcy cases. The *Fisker Automotive* decision out of the Delaware bankruptcy court limiting the amount of a distressed debt buyer's credit bid at a Section 363 sale to its purchase price has invigorated counter arguments to 'loan to own' acquisitions. ERISA liability issues, such as the withdrawal liability associated with multi-employer plans at issue in the *Sun Capital* case out of the First Circuit, have been a wake-up call for private equity groups.

Durrer: Early in August 2014, federal regulators expressed their displeasure with the living wills submitted by the 11 largest US banks pursuant to the Orderly Liquidation Authority promulgated as part of the Dodd-Frank Act born of the 2008 Great Recession. Some believe that this regulatory action was prompted by efforts on Capitol Hill to force such large failing banks into bankruptcy – as part of a new Chapter 14 – rather than leave them subject to the regulatory regime set up by the Dodd-Frank law. We intend to continue to monitor this tug of war which involves a broad spectrum of possible – and very politically-driven – outcomes ranging from new bankruptcy legislation for banks to some dismantling of large banks.

Espejel: The recent legal reform to the LCM, as well as the 2014 introduction to the Mexican Law of Credit Institutions of the court-assisted liquidation proceedings for banks, will surely have an important effect on bankruptcy and restructuring in Mexico. In addition, this year has seen the bankruptcy filings of some major homebuilders in Mexico, as well as the involuntary filing of a major supplier of the National Oil Company of Mexico (PEMEX), which will test the effectiveness of the bankruptcy reforms and the benefits for both debtors and creditors in filing cases under the new amendments to the LCM. New guidelines introduced by the amendments to the LCM to important topics such as the treatment of intercompany and insiders' debt, debtor-in-possession financing, corporate groups, bankruptcy and D&O liability, and reformed pre-packaged bankruptcy, are currently under review in the ongoing bankruptcy proceedings of *Corporación GEO, S.A.B. de C.V., Desarrolladora HOMEX, S.A.B. de C.V.* and *Oceanografía, S.A.B. de C.V.*, which are large cases that will constitute precedents in all those important matters.

Alfonso: The Supreme Court's ruling in *Executive Benefits Insurance Agency v. Arkison* was a highly anticipated decision that is getting a lot of attention, even though the decision was narrower than many had hoped. We now know that at a minimum, with the consent of the parties, bankruptcy courts can enter proposed findings of fact and conclusions of law on bankruptcy-related 'core' fraudulent transfer claims, subject to *de novo* review by the district court. The Supreme Court declined to address the broader issues that *Stern* left open, such as whether bankruptcy courts can enter proposed findings without the parties' consent. The Delaware bankruptcy court's ruling in *Fisker Automotive* may impact how credit bidding is used and valued by distressed investors, which have historically used credit bidding as a tool to acquire distressed assets. *Fisker* limited a secured lender's credit bid to the amount the lender paid for the claim, which was substantially below par, in order to promote a competitive auction process. The basis for the ruling was fact-specific, but the *Fisker* holding has already been followed by at least one other bankruptcy court – *Free Lance-Star*. Fisker has the potential to influence pricing in the secondary loan market because of the uncertainty that the holder will get the full credit bid right associated with the claim.

Golubow: The Delaware bankruptcy court's decision this past January in *In re Fisker Automotive Holdings, Inc.* has cast a shadow of a doubt onto the extent of a secured creditor's ability to credit bid. Briefly, the *Fisker* court limited a secured creditor's credit bid to the amount paid for the secured debt instead of the face value of such debt under Bankruptcy Code Section 363(k) which allows for credit bidding by a secured creditor "unless the court for cause orders otherwise". This decision contributes to a growing body of jurisprudence which has strengthened bankruptcy courts' ability, under this provision of the Code, to deny or limit a secured creditor's right to credit bid in order to create "a competitive bidding environment". It is still too early to gauge the effect of this decision but it is possible that *Fisker*, and the trend it illustrates, could result in increased litigation regarding what constitutes "cause" to limit a secured creditor's ability to credit bid the full amount of its debt, thereby slowing down the pace of 363 sales, and negatively impact the claims trading market by limiting the perceived benefits of purchasing claims held against a distressed business.

MacParland: There haven't been any significant developments in Canadian insolvency legislation in the past 12 months. We have had a number of interesting court decisions that have impacted the practice area including *Livent Inc. (Special Receiver and Manager of) v. Deloitte & Touche 2014* ONSC 2176, which found auditors liable for failing to discover fraud in a timely manner, although this is subject to appeal. *Newfoundland and Labrador v. Abitibi Bowater Inc.*, 2012 SCC 67 and *Nortel Networks Corporation (Re)*, 2013 ONCA 599 considered the circumstances in which environmental claims can be compromised. *Re Crystallex International Corp.*, 2012 ONSC 6812 dealt with claim procedures and *Sun Indalex Finance, LLC v United Steelworkers*, 2013 SCC 6, [2013] 1 SCR 271 dealt with the super-priority of interim financing and the priority of certain provincial deemed trusts, as well as certain directors' duties.

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ANA M. ALFONSO

Kass: Recently Congress proposed to extend Chapter 9 provisions to the Commonwealth of Puerto Rico which would allow the Commonwealth to restructure certain assets as is routinely done in municipal restructurings through the United States. Though at this point it is unclear as to whether this is an avenue the Commonwealth needs to follow, it is a development worth watching. Additionally, the new healthcare legislation may have a significant impact on companies in that industry. As the legislation rolls out and takes effect, companies will have to deal with the changing payer system and face some fundamental shifts in their business models.

Shaw: How would you characterise the current market for distressed M&A activity? What strategies and techniques are distressed investors employing to get deals done?

Durrer: Many acquirers of distressed targets are proposing 'stalking horse' bids to obtain favourable bidder protections in an effort to manage competition. As a consequence, it is rare that stalking horse bidders will be 'unseated' even in a competitive process. Sometimes this is less a consequence of the bidder protections and more a consequence of the target's professionals doing a good job of vetting potential suitors to identify a strong stalking horse candidate in the first place.

Alfonso: Strategic acquirers are getting ample support from the capital markets for opportunistic purchases of distressed companies or their assets. Lenders to the target are getting more active on the sell side and are showing more willingness to take equity or restructured paper rather than consent to a release of the collateral for less than par. Under the right circumstances, this dynamic can maximise value by encouraging serious bidders to make their best offers and reducing the risk that the buyer will try to renegotiate on the eve of closing.

Golubow: Activity has definitely increased in 2014, particularly for middle market companies and commercial real estate projects. With the Affordable Care Act underway now, there also is increasing consensus from restructuring professionals that the healthcare industry will create opportunity for distressed investors. As far as getting deals done, distressed investors are finding that credit, both from traditional banks and alternative sources such as foreign capital, conduit, bridge, and mezzanine lenders, is more accessible now, particularly for credit-worthy investors. Distressed investors also are looking for ways to avoid bankruptcy, if possible, because of the expense, the somewhat protracted length of time and the transparency which necessarily invites competing bids from other prospective purchasers.

MacParland: Currently, there is a strong, frothy market for distressed M&A in Canada. There are three hallmarks of the present market: shorter timelines – Canada has seen a resurgence of quick flip sales – which are characterised by very short timelines; avoidance of cross-border court proceedings; and non-court supervised distressed transactions and private remedies.

Kass: The limited amount of distressed companies and increased availability of credit is resulting in an extremely competitive distressed M&A environment. Many companies are avoiding or delaying in-court restructurings through covenant amendments or forbearance extensions. Investors are capitalising on the fact that many distressed companies are seeking these alternative routes to avoid filing for Chapter 11. The current outlook has investors focusing on the consumer and retail sector which is expected to struggle in late 2014.

Dorsey: The current market is modest, although healthcare may lead the way towards greater activity. The predominant strategy continues to be 'loan to own' through the purchase of senior secured debt, often at a discount, followed by a limited use of bankruptcy to accomplish a Section 363 asset sale, followed by a structured dismissal. Depending on the complexity of the capital structure of the target, these transactions may occur out of bankruptcy, through foreclosures, assignments for the benefit of creditors, or receiverships. Reorganisations and plans of liquidation seem to be largely off the table as private equity players driving the process often see such options as too slow, expensive and lacking control.

Mexico does not have a rule preventing shared information from being used as evidence in a court of law, and confidentiality agreements may not be strong enough to prevent disclosure of such shared information as evidence in a judicial process.

ENRIQUE ESPEJEL

Shaw: What themes are you currently seeing with regard to disputes and litigation as part of the bankruptcy process? Are disputes out of bankruptcy growing in complexity and lengthening the process?

Espejel: Collection efforts commenced before the filing of a bankruptcy petition are common topics within the insolvency process. Participating creditors are expected to refrain from enforcing their claims during the negotiation period. This is achieved by entering into a standstill agreement. Standstill agreements may provide for undertakings by each creditor refraining from pursuing individual action against the debtor or its assets, challenging other participating creditors' claims and taking any action to improve the relative position of a creditor to the detriment of other participating creditors. They also include similar undertakings from the debtor and other terms such as a sharing of information and lock-up covenants. The validity and enforceability of undertakings by creditors refraining from exercising procedural rights is questionable and specific performance may be unavailable. The exchange of information raises another legal issue – Mexico does not have a rule preventing shared information from being used as evidence in a court of law, and confidentiality agreements may not be strong enough to prevent disclosure of such shared information as evidence in a judicial process. In essence, standstill agreements executed during the pre-filing stage aim to prevent the exercise of credit recovery actions in order to maintain negotiations with the debtor, but in practice creditors tend to file their lawsuits despite their agreement of not exercising legal actions before a specific date or event. The effect of these disputes is only to trigger the filing of the voluntary petition to avoid the foreclosure or enforcement of guarantees or to avoid any attachment of the debtor's assets. Except for labour claims that are not stayed as a consequence of the bankruptcy proceeding, generally claims against the bankrupt are stayed as well as almost any enforcement actions against the estate.

Alfonso: Bankruptcy-related disputes are often complex simply by virtue of the number of interested parties, even when the issues are straightforward. However, bankruptcy litigation is generally more expeditious than litigation outside of the bankruptcy court. Part of this dynamic is the time-sensitive nature of the bankruptcy process, but expediency is also driven by bankruptcy judges who often set aggressive litigation schedules to encourage settlement and minimise delay of the broader proceedings. Unfortunately, because of the Supreme Court's recent rulings that limit or raise doubts about a bankruptcy court's power to enter final orders in litigation, we may start to see more delay as overburdened district courts are required to be involved in certain matters. I think the bankruptcy bench is very focused on this issue and will look for creative ways to ensure that bankruptcy proceedings are not stymied by the presence of so-called *Stern* matters.

Golubow: Disputes and litigation are playing as large a role as ever in the bankruptcy process, whether in the context of disputes over the valuation of a debtor's assets, the extent or value of a secured creditor's claim, or preference and fraudulent transfer actions. That being said, due to the high expense and length of time associated with a bankruptcy proceeding, out-of-court restructurings have taken on a new allure for troubled businesses that seek to renegotiate their debt without commencing a bankruptcy proceeding. Accordingly, more and more distressed businesses are seeking out-of-court resolutions of claims held against them and disputes related thereto. Out-of-court restructuring does not provide the same protections to a debtor as a bankruptcy filing, however, and many of those businesses that find the idea of resolving their disputes outside of the courtroom appealing may discover that bankruptcy is their only viable option, in the event that their circumstances require immediate protection from the actions of creditors.

MacParland: There is no doubt that disputes in insolvency proceedings are becoming increasingly complex. The *Nortel* proceedings have provided a microscope through which Canadian practitioners are evaluating the effectiveness of the current insolvency dispute and litigation resolution framework. In addition, Canadian insolvency practitioners are under increasing pressure to provide their services on a more cost effective basis.

Kass: With increased access to capital and less urgency to seek protection under Chapter 11, debtors, creditors and their professionals are able to pre-negotiate and reach a consensus on many of the contentious issues that may come up in a typical restructuring Chapter 11 proceeding. With a pre-packaged plan in place, the timeframe of the Chapter 11 process can be shortened and many of these issues can be resolved before the company even files.

Dorsey: In the area of 'loan to own' bankruptcy acquisitions through Section 363 sales, there has been an increase in litigation over the right to credit bid, the proper amount of the credit bid, and related acquisition issues as unsecured creditors try to extract some value from the process. Efforts to create a return for unsecured creditors where core asset values are lacking has resulted in a rise in the number of claims being brought based on breach of fiduciary duty, insider transactions, fraud, professional malpractice and an array of avoidance claims. Often these types of claims may be the only unencumbered asset with any potential value in a liquidating case, and so creditors have increased incentives to pursue the claims. These types of residual claims tend to be factually intensive and legally complex, extending resolution of the bankruptcy for a number of years. The bankruptcy authority issues raised by *Stern v. Marshall* present threshold issues that allow targets of substantial claims the ability to delay litigation, increase cost for the estate and leverage settlement.

Durrer: There are definitely situations where litigation is pursued as a strategy to generate leverage. The more extreme the situation, the more complex the litigation can become. The US judicial process itself tends to be litigation 'friendly' in that it is expensive, time-consuming and difficult to dispose of litigation that has, at its core, genuine issues of material fact. There is something of a balance, however, because often the majority of parties all favour a successful restructuring, so negotiated consensual resolutions are frequent.

Shaw: What are the common types of disputes dominating today's bankruptcy proceedings? What strategies can you employ to address these common disputes and achieve a successful restructuring?

There are definitely situations where litigation is pursued as a strategy to generate leverage. The more extreme the situation, the more complex the litigation can become.

VAN DURRER

Alfonso: Not every bankruptcy case is dominated by disputes. Many of them are largely consensual. The most contentious cases going on right now involve valuation disputes or power plays among investors in different parts of the capital structure. Conflict can lengthen a bankruptcy process and make it very costly, but as long as the debtor has access to financing during the bankruptcy, there is always hope for a successful restructuring.

Golubow: Challenges to a bankruptcy court's jurisdictional authority to enter final orders on a number of issues commonly found in bankruptcy litigation, such a fraudulent transfer claims, continue to proliferate in the wake of the Supreme Court's 2011 decision in *Stern v. Marshall*. Most recently, this past June the Supreme Court handed down its decision in *Executive Benefits Insurance Agency v. Arkison*, in which the Court clarified *Stern* by setting forth the procedures by which bankruptcy courts must decide so-called *Stern* claims: the bankruptcy court may provisionally rule on such claims but must submit its findings and recommended ruling for *de novo* review to the district court. The Supreme Court declined, however, to rule on one of the major issues presented in *Executive Benefits*, namely, the constitutional issue whether a party may consent either affirmatively or via waiver to a bankruptcy court's final adjudication of *Stern* claims. Until this issue and others raised in *Stern* are resolved or further clarified, it is imperative that litigants continue to be vigilant to protect their constitutional rights and have matters heard in the appropriate tribunal.

MacParland: It is difficult to precisely characterise the types of disputes dominating current proceedings. However, it is clear that significant knotty disputes arise where the insolvency regime is not fully harmonised with other regulatory or statutory regimes, such as pension, labour, construction liens, environmental and taxation.

Kass: Chapter 11 proceedings are often afflicted by valuation fights and disputes over creditor recoveries, which can result in a significant delay in emergence or wind-down and increased professionals fees. To avoid this, many troubled companies attempt to negotiate with creditors prior to entering Chapter 11 in order to ensure a streamlined and fast-tracked restructuring process.

Dorsey: Common disputes consist of the raft of residual claims being brought against officers, directors and professionals in the aftermath of the business failures, including claims for breach of fiduciary duty, professional malpractice and negligent misrepresentation. *Stern v. Marshall* litigation over the authority of bankruptcy courts continue to create threshold issues that extend and complicate resolutions. Mediation can play a large role in the strategy for resolving major litigation before the time, cost and complexity diminishes any positive return for the creditor body.

Durrer: The two most frequent sorts of disputes arising in bankruptcy proceedings involve valuation and process, and they are interrelated. For example, a valuation dispute typically arises where a senior stakeholder has a low opinion of enterprise value whereas a junior stakeholder will have a higher opinion of enterprise value. While there are examples of bitterly fought contested valuation battles, a negotiated or mediated settlement as to value is more of the norm. The second example is a dispute over process. This is related to value in that the challenger complains that the process undertaken by the distressed company did not result in the highest value for all constituents.

Espejel: There are three main types of action commonly exercised by creditors within a bankruptcy proceeding. The first of these are motions to separate property from the bankrupt estate. Any legitimate title-holder – not necessarily an owner – may separate individually identified assets in the debtor's possession, provided such assets were not transferred to the debtor pursuant to a final and irrevocable legal title. To be separated, an asset must be in the debtor's possession, individually identified, and may not have been transferred pursuant to a final and irrevocable legal title. The second type is fraudulent conveyance actions, including modifying the 'look-back' period. Some types of transactions carried out prior to the declaration of bankruptcy or *concurso* can be set aside. The transactions subject to avoidance are grouped in four categories: *per se* fraudulent transactions; cases of constructive fraud; objective preferences; and subjective preferences. All pre-commencement *per se* fraudulent transactions are avoidable, as well as all other avoidable transactions if both types of transactions are carried out within the retroactive period or 'look-back' period. The third type of action is challenging the credit recognition process. Within the process of credit recognition, any creditor can contest and object to the amount and ranking of its credit claim, if done or recognised in different terms as originally requested.

One strategy we've seen creditors employ in various restructurings is purchasing additional debt of the distressed company prior to filing, thus allowing them to assert more leverage during the process.

ALBERT H. KASS

Shaw: What methods do you see creditors using to assert their claims against insolvent debtors, in an attempt to recover as much value as possible?

Espejel: Creditors may opt to commence collection actions against debtors even before the bankruptcy proceeding is filed in order to obtain a better position by attaching assets and bank accounts and pressuring the debtor with other preventive injunctions. In the absence of payment or default by a debtor of a loan or credit, creditors must claim, *inter alia*, the declaration of default or non-payment of the corresponding unsecured loan or credit or promissory note, and the payment of the full amount of the debt. The demand may be brought before the Mexican federal or local courts through the ordinary commercial proceeding, or the summary commercial proceeding. The proceeding to obtain the declaration of non-payment of the credit or note and its collection is governed by the Mexican Commerce Code and the Federal Civil Proceedings Code. The ordinary commercial proceeding is comprised of seven successive stages: preparation, exposition, proofing, conclusion, resolution, appeal and execution. There is no 'discovery period' under Mexican law. During the preparation stage, creditors may carry out one or more measures in anticipation to litigation.

Kass: One strategy we've seen creditors employ in various restructurings is purchasing additional debt of the distressed company prior to filing, thus allowing them to assert more leverage during the process. Depending on the details of the plan of reorganisation, this may provide that creditor with a greater ownership stake of the reorganised company upon emergence. In addition, creditors continue to push for negotiations with debtors to reach a consensus on a plan prior to filing for bankruptcy in order to keep the cost down and shorten the duration of time spent in bankruptcy.

Dorsey: Senior secured creditors continue to be inclined to monetise their claims through either pooling troubled debt for sale to distressed debt purchasers or executing on isolated sales to private equity groups wishing to employ a 'loan to own' strategy. Unsecured creditors, having limited hope of recovery from the sale or forced liquidation of core assets, are most likely to seek recovery through the pursuit of residual causes of actions ranging from asserting claims for breach of fiduciary duty, professional malpractice claims, or avoidance claims, targeting potential deep pockets, and pursuing claims against insurance. This may be coupled with the acquisition of 'seed money' from the senior secured lender in return for cooperation with the 'loan to own' strategy. The prevailing strategy is to get a return on claims as quickly as possible, avoid the expense of protracted reorganisation or liquidation cases if possible, and, if extended litigation of residual claims is necessary to achieve a return, use ▸▸

contingency fee or litigation financing to pursue such recoveries.

Durrer: Much ink is spilled today on developing techniques or technology to avoid, or in some instances predetermine, the outcome of bankruptcy cases. This is commonly referred to as 'bankruptcy-proofing' or 'bankruptcy-remoteness'. Many court opinions are split as to the success or failure of the various techniques, but they are highly dependent on the particular facts and circumstances.

Golubow: The most common method creditors use to assert claims against insolvent debtors is to challenge the actions of a debtor's board of directors and its officers in an attempt to recover from any directors' and officers' liability insurance policy that may exist. Indeed, the proceeds from a D&O insurance policy may be the only avenue of recovery available to general unsecured creditors. Recently, the Delaware Court of Chancery – a Delaware state court – issued its opinion in *In re Rural Metro Corp. Stockholders Litigation*, in which the court criticised the role of the company's financial advisers in "aiding and abetting" the board in breaching their fiduciary duties during the sale of the company to a third party. Going forward, if there are no sources of recovery including a D&O insurance policy available to unsecured creditors in a bankruptcy estate, creditors will no doubt seek to apply *Rural Metro* to pursue the next 'deep pocket' from which creditors may otherwise recover.

MacParland: There has been a prevalence of strategic motions brought within insolvency proceedings by creditors, particularly where the law or statues are unclear. Although, in respect of less aggressive creditors, we are seeing a return to the use of receiverships and the increased use of creditor supported CCAA liquidating sales processes. The effective use of corporate arrangements requires the cooperation of priority creditors and as mentioned above that is also on the rise due to speed and certainty of recovery.

Shaw: To what extent are dissatisfied creditors more likely to target directors and officers, professionals or other advisers in post-bankruptcy litigation? What types of claims are they bringing against directors and officers?

Golubow: While the aggregate number of claims and suits against directors and officers has declined from peak figures seen after the financial crisis, there has been a dramatic increase in the number of D&O suits initiated by the Federal Deposit Insurance Corp. against directors and officers of failed financial institutions. In the private sector, directors and officers still remain the target of post-bankruptcy litigation, particularly on the grounds that the management – or mismanagement – of the directors and officers directly resulted in the bankruptcy filing or ultimate failure of the company. In such instances, creditors' committees or trustees assert claims, on behalf of the larger body of creditors of a debtor's bankruptcy estate, against directors and officers are for breach of their fiduciary duties, to the company and its shareholders. Also, the *Rural Metro* decision makes clear that although a breach of fiduciary duty claim might exist, but not provide any meaningful recovery to creditors, the conduct of professionals in aiding and abetting or assisting that Claims are typically asserted for breach of duty of care or loyalty, breach of trust, aiding and abetting such breaches, fraud, unlawful dividends, insider preferences, professional malpractice, negligence or gross negligence and negligent misrepresentation.breach may provide an avenue for recovery.

Claims are typically asserted for breach of duty of care or loyalty, breach of trust, aiding and abetting such breaches, fraud, unlawful dividends, insider preferences, professional malpractice, negligence or gross negligence and negligent misrepresentation.

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MacParland: Such claims are almost exclusive government-type claims involving statutory liability provisions. Successful tort claims or oppression remedy claims against directors remain rare. The best example is the recent decision of *Baker v. Ontario (Director, Ministry of the Environment)* 2013 ONSC 4142, in which the former directors and officers of the bankrupt company Northstar Aerospace (Canada), Inc. (Northstar) were confirmed liable for interim remediation costs under a Ministry of Environment (MOE). The former directors were unable to obtain protection through either insurance or the CCAA process. Ultimately, the matter was settled between the former directors and the MOE prior to a final determination. However, given the facts – the directors were not on the board at the time of the discharge and Northstar was using best efforts to comply – the decision is disconcerting for directors and officers.

Dorsey: The likelihood is quite high because of the decline of true reorganisation cases, the increase in quick acquisition sales, and the reality that such claims may be the only hope for a meaningful return to unsecured creditors. Claims are typically asserted for breach of duty of care or loyalty, breach of trust, aiding and abetting such breaches, fraud, unlawful dividends, insider preferences, professional malpractice, negligence or gross negligence and negligent misrepresentation.

Durrer: There are definitely a growing number of instances where so-called 'out of the money' creditors will seek recoveries from directors and officers. The claims will range from fraud, which requires the creditor to demonstrate specific misrepresentations that D&Os made to that creditor on which the creditor reasonably relied, which can be rare, to claims of breach of fiduciary duty, which are truly the company's claims, so the creditor must have obtained permission to bring such claims or otherwise have a viable right to do so. This last instance could arise where the company is insolvent and has failed to pursue the claims itself.

Espejel: With the legal reform of the LCM a whole new set of rules governing potential liability for directors and officers of a distressed company have been introduced, so that creditors have additional legal actions against the debtor's management. The rationale behind the reform is that during the 'zone of insolvency' – when in equitable insolvency or balance sheet insolvency – of the debtor, its directors and officers owe fiduciary duties to exercise their business judgment in the best interest of the insolvent company for the benefit of its shareholder owners, while continuing to bear the task of attempting to maximise the economic value of the firm for any potential residual benefit to the shareholders. Directors and officers liable to the corporation for loss incurred in corporate transactions during the zone of insolvency will be subject to claims for damages. As to D&O liability regarding fraudulent transfers, the general rule under the LCM is that a director or officer of a corporation does not owe fiduciary duty to creditors of the corporation. However, when a director or officer is involved in any fraudulent conveyance as defined by the LCM, according to the new rules, he becomes liable also to the debtor's creditors.

Alfonso: It is standard operating procedure for creditors committees to investigate potential claims against directors and officers that can be pursued for the benefit of unsecured creditors. Potential D&O claims are used as currency in plan negotiations and are often preserved for pursuit on behalf of creditors post-bankruptcy if there is perceived litigation value and available D&O insurance coverage. Even in cases where the debtor gives releases to the directors and officers, courts are making it more difficult to include non-consensual 'third party' releases of directors and officers in Chapter 11 plans. As a result, D&Os are at greater risk of being sued by creditors post-bankruptcy. The types of claims I see most frequently are breach of fiduciary duty claims based on a director's or an executive officer's alleged participation in facilitating a fraudulent transfer of estate assets or other acts that allegedly dissipated value.

Shaw: Considering the risk to D&Os, professionals or other advisers of facing legal action following a bankruptcy event, how can they protect themselves against such situations?

We recommend that directors and officers of distressed organisations ensure they have sufficient and comprehensive insurance to cover all the risks associated with acting in that capacity, as well as the pre-negotiated right to obtain a tail policy if necessary.

NATASHA MACPARLAND

Kass: Dissatisfied creditors can and likely will target a number of parties when the results of the restructuring are not in line with their expectations. Directors and officers may face actions resulting out of decisions made when the company is inside the 'zone of insolvency'. One avenue the directors and officers should take prior to a restructuring is to bring in qualified professionals early in the process. These professionals can advise them as to potential pitfalls and legal intricacies when facing an insolvency. Strategic communication professionals can also be a valuable resource in effectively addressing creditors concerns and streamlining communications with all constituencies. Oftentimes, use of the 'business judgement rule', in conjunction with the guidance of these professionals, will protect the directors and officers as long as decisions were made in good faith.

Dorsey: By the time an insolvency professional is employed, the events giving rise to potential D&O exposure have typically occurred. The limited objective is to not make the situation worse. On a go forward basis, this may involve increasing transparency, assuring that best practices are followed in reaching, documenting and executing business decisions, which often includes the retention of professional advisers, and, where appropriate, engaging an impartial restructuring professional to make critical business decisions to improve the optics of the management process and diffuse distrust. Attention should also be devoted to preserving and extending D&O coverage, with particular focus on the scope of coverage and conditions relating to the payment of defence costs pending determination of coverage disputes. As for professionals, both existing and insolvency related, protective measures include a thoughtful use of engagement letters to define duties and liabilities, faithful execution in accordance with that carefully crafted engagement letter, and due regard for the separation between the professional's role and the role of corporate decision makers.

MacParland: We recommend that directors and officers of distressed organisations ensure they have sufficient and comprehensive insurance to cover all the risks associated with acting in that capacity, as well as the pre-negotiated right to obtain a tail policy if necessary. This often requires amendments to the coverage as some risks are not covered by a traditional policy. It is helpful to have that discussion with the company and its insurers early so that it doesn't become a distraction on the eve of an insolvency proceeding. For risks that can't be adequately insured, we recommend establishing protective trusts. Within an insolvency proceeding, any initial order should provide certain charges and protections for the directors and officers. Finally, if appropriate and warranted, the directors and officers should receive the benefit of releases and discharges within the proceeding.

Durrer: One of the best – but by no means only – protection that D&Os can employ is the participation of independent directors and advisers. A common criticism levelled at D&Os involve the interest of a director or officer in a transaction, or, in particular, the release or exculpation that the director or officer may receive as a consequence of the transaction. Review of the transaction by disinterested directors and advisers is a powerful way to deflect such claims. In addition, such a review may short-circuit bankruptcy litigation over such issues, which would be very valuable to a struggling company seeking to emerge from Chapter 11.

Alfonso: If a company is at or near the point of insolvency, it is critically important that directors and officers understand and fo- ▸▸

cus on their duties to creditors. Legal counsel should be consulted when making decisions about how, when and where to deploy scarce financial resources. It is generally best to start consulting restructuring advisers at the first sign of distress and begin a dialogue with the company's major stakeholders as early as possible, to allow the parties time to work on a solution before the onset of a liquidity crisis. The company's lenders are more likely to be able and willing to help when the company's directors and officers are open about potential defaults and are perceived as being constructive in restructuring discussions.

Golubow: The best time to consider and employ protective measures is well before a company faces distress and when an insurer is more willing to provide or enhance coverage, but the reality is that a company's D&Os are often too busy or too concerned about cost to adequately protect themselves. Education is key and D&Os should ask many questions of the company's risk manager, CFO or general counsel about the scope and breadth of their D&O insurance policies. For example, does the policy include coverage for regulatory or criminal investigations? An insured versus insured clause? A severability clause so that wrongful, fraudulent or criminal activity of one insured does not affect coverage for others? D&Os also should review the company's D&O insurance coverage at least semi-annually to ensure appropriate coverage as options and the company's circumstances may change.

Espejel: The amendments to the LCM adopt the business judgment rule to shield directors and officers from liability arising from decisions that are made on an informed, statutory, good-faith basis, and with reasonable skill and prudence with an honest belief that the decisions are in the firm's best interest. In addition, to mitigate the risk of D&O liability and the outcome of legal actions brought for alleged wrongful acts in their capacity as directors and officers, according to the LCM, the debtor's officers may have access to insurance or bonds to cover the amount of the damages incurred or awarded. This is a valid corporate benefit as long as the conduct of such officers is not related to bad faith and wilful misconduct or their activities are not considered illicit under Mexican laws and regulations.

Shaw: Going forward, what is the outlook for corporate bankruptcies in your region over the next 12 months? To what extent are banks likely to support struggling debtors?

Kass: Recently companies have benefited from low interest rates and increased access to credit, resulting in a significant decline in bankruptcy filings. Rates should remain low throughout the remainder of 2014 but are widely expected to rise in 2015. Depending on the magnitude of this rate increase, it may prompt a surge in corporate bankruptcies. The consumer and retail sectors have seen significant benefit from available capital through 2014, delaying the need for restructurings or liquidations, and thus may be a victim of these potential changes in 2015. We continue to experience declining industries and management incapable of implementing cost cutting efficiencies which, despite access to capital, will result in out-of-court restructurings or Chapter 11s.

Dorsey: As a whole, corporate bankruptcies remain in a developmental stage. The speed of the development will be dictated by an array of factors, including changes in the interest rate, the continuing strength of credit markets and other economic factors. If interest rates remain low and lending robust, it is difficult to see a material increase in filings, other than through distressed transactions in the healthcare industry, additional filings by governmental entities and the occasional fallen star business. In all likelihood, the next 12 months will see at best a modest increase in corporate bankruptcy filings in the region.

Durrer: In recent weeks, we have seen speculation that Russia may invade Ukraine, the EU economy may falter, increased US airstrikes and a potential new government in Iraq and mixed signals regarding the strength of the US economic recovery. Any one of these global factors could have an effect on the outlook of corporate bankruptcies in the next 12 months, so the short answer is that predictions are difficult here. Assuming the absence of one or more global catastrophes, the sense is that filings will be consistent with the new normal, and that the capital markets will remain open to supply rescue financing if needed.

Espejel: The bankruptcy market will be active for the next 12 months as companies will continue struggling due to macroeconomic factors – essentially a contracted economy in the short term. Banks will likely continue to support bankruptcy proceedings as their goal is to maximise recovery in insolvency scenarios, where DIP financing and close involvement in restructuring proceedings are key factors.

Alfonso: Market conditions do not suggest a near term uptick in corporate bankruptcies. The lending environment is still borrower-friendly, interest rates are still at historic lows and private equity sponsors are still looking for new product. Struggling debtors will continue to have options. On the other hand, banks may have less flexibility to provide support to struggling debtors as they wrestle with the Federal Reserve's leveraged lending guidelines that went into effect last year. The Fed has been vocal recently about its concerns that there may be too much appetite for risk in the leveraged loan market. I have seen reports suggesting that banks are bracing themselves for the possibility of being fined by US bank regulators for participating in deals with too high of a leverage ratio. These concerns may have an effect on some lenders' willingness to agree to the covenant-light, borrower- friendly terms that are currently available.

MacParland: I expect much of the same for the next 12 months. There are no mega-insolvencies looming. Accelerated sales processes inside a variety of proceedings will likely continue. I think there will be an even more pronounced use of corporate arrangements for balance sheet restructurings as well as receiverships for midmarket distressed entities.

Golubow: The ongoing trends of low interest rates and the ability of distressed companies to extend their debt maturities or access inexpensive financing will continue to suppress the overall number of bankruptcy filings in the near future. This paradigm, however, cannot maintain itself indefinitely and once interest rates begin to rise, the flood of bankruptcies that have so far been delayed will be unleashed. In addition, there are a number of industries that will likely see an uptick in bankruptcy activity prior to any changes in monetary policy. Brick-and-mortar retail businesses are especially vulnerable, as they are steadily losing their share of the marketplace to online retailers while maintaining significant overhead, such as expensive leases, that their online counterparts do not have. ■