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INDUSTRY OVERVIEW

Unravelling corporate capital structures

BY CLAIRE SPENCER

Things have changed dramatically for restructuring and insolvency practitioners over the last year. After the US subprime crash, generous credit margins were squeezed, liquidity began to dry up, and shockwaves resonated through the global market. However, North America has borne the brunt of the impact, and many commentators believe that the actions of the Federal Reserve have exacerbated their woes. As North America, and the US in particular, awaits the inevitable market correction, or even recession, those involved in restructuring and insolvency can finally prepare for an influx of cases. Distressed companies will undoubtedly fall first, but if the downturn is prolonged, even 'healthy' companies may find themselves seeking Chapter 11 protection. The focus is still on restructuring over formal bankruptcy, but this is likely to be more complicated than ever, due to increasingly bitter intercreditor battles.

The last 12 months have seen the emergence of several macroeconomic trends, including rising inflation, tightening credit, reduced liquidity, high energy prices, and rising unemployment. The US Federal Reserve attempted to counteract the credit and unemployment issues by forcing interest rates down, which has caused inflation to rise. The general consensus is that its actions are only delaying the inevitable. Indeed, some commentators believe the US economy is already in recession. The North American market has reacted by significantly revaluing assets and repricing risk, the effects of which have been considerable. "On the consumer level, the subprime mortgage fiasco has undermined the value of residential real estate with the greatest impact being felt in the US," says Kevin McElcheran, a partner at McCarthy Tétrault. "On the corporate level, the increase of spreads demanded by lenders is severely impacting M&A activity, complicating refinancing of corporate debt and reducing profit margins. Additionally, widening spreads are stressing derivative trading, driving substantial write downs by major financial institutions on their credit derivative portfolios and, in Canada, making the restructuring of third party asset backed commercial paper, a $35bn problem that has remained unsolved since August 2007, more and more difficult to fix." As such, lending has ground to a halt at most major banks, which are unable to syndicate their backlogs of debt. Furthermore, trading between the US and Canada has become increasingly difficult for several sectors, due to the juxtaposition of the US weakening currency against the strengthening Canadian one.

The loan and finance markets are in trouble while current conditions prevail. Some firms have found themselves on the verge of default. However, it is possible that companies which managed to acquire favourable lending conditions during the boom phase may, temporarily, feel less of a pinch, according to Anthony H.N. Schnelling, managing director at Bridge Associates LLC. "Loans with few or no covenants or security will help companies so long as there are no senior secured loans ahead of them. To the extent that there is a senior secured position, the difficulties we have seen in the financial markets since summer 2007 spell disaster for companies that experience a need for liquidity or operational difficulties. Most lenders are pulling back on new lending for the reasons stated above and are watching collateral and credit much more carefully. This doesn't bode well for refinancing companies that are in trouble. In addition, those companies owned by sponsors will find them in many cases less willing to throw cash at a problem than before because of liquidity issues being experienced by the sponsor group." The alternatives for the sponsors are to sell or restructure. Ultimately, if these companies are able to borrow, they will be doing so at a premium. If they cannot borrow, then they will have to face a monetary default at some point in the future, unless circumstances improve quickly.

Before long there may be droves of troubled companies seeking Chapter 11 protection while they re-evaluate their balance sheets and business models. This could be a positive step for companies that have avoided underlying issues for too long. "Sometimes management needs to be faced with a crisis, such as insolvency, to make difficult decisions to improve the overall health and viability of a company," observes D.J. Miller, a partner at Thornton-GroutFinnigan LLP. "When considering the financial requirements and preparing cash flows for a restructuring, all avenues for improving efficiency and conserving cash are reviewed. A formal insolvency proceeding provides the opportunity and forum within which an operational restructuring can be achieved, particularly if it includes the termination of employees or obtaining concessions from employees. Outside of an insolvency proceeding, few employees or unions are likely to grant any concessions or agree to any terms amending existing employment arrangements." On the other hand, this downturn may also see operationally sound companies becoming distressed due to debt maturities or financial defaults. In these cases, an informal restructuring of the balance sheet may be sufficient to improve matters.

Dealing with complex credit structures

Restructuring has become more complicated in recent years. The M&A and liquidity boom saw the introduction of new, highly creative debt tranches, and the average number of creditors in restructuring cases has increased accordingly. "Capital structures have become much more complicated as innovative lenders and financial advisers have developed many sophisticated financing techniques that have resulted in complex debt structures," asserts

Harvey R. Miller, a partner at Weil, Gotshal & Manges LLP. "The advent of mezzanine or second lien financing and special purpose vehicles or entities and complex corporate structures will result in substantially more litigation that may prolong or derail restructuring efforts. Taking bankruptcy and insolvency as zero sum gains, parties who may be outside the projected valuations of a particular entity may resort to litigation as a means of obtaining leverage. The leverage would be used to extract some value for the particular sum value for the particular litigants."

Litigation is on the rise, and the relationships between senior and junior lenders are already causing problems. According to Mr McElcheran, M&A transactions funded by more than one syndicate, but with cross participation both at the agent and lender level, may face some significant governance issues as the loans default and lenders jointly participate in a restructuring. "To further complicate matters, positions in all loans can trade either among the existing group or with outsiders seeking to trade further or to acquire a position in the company's debt as part of an acquisition strategy. In most cases, a lack of common purpose among the senior lender groups will not imperil the restructuring as most participants will be working to preserve the business in order to maximise value and will only be battling over their respective shares or control of the company. That being said, the additional complication of collateralised debt obligations and CDS protection may force some secured lenders to seek a liquidation in order to trigger or preserve rights under their credit protection," he says. As a result, many practitioners are anticipating restructuring negotiations that are far more costly, time-consuming, and convoluted. Although most of the senior lenders involved in recent restructurings have been protected, some junior lenders are fighting to extract any value out of the situation at all.

As a result, it is in the best interests of many troubled companies to reorganise outside of the formal bankruptcy process, although their ability to do so largely depends on how much is owed and how much is needed to continue. "If the financial restructurings require modification to multiple, disparate constituencies, as opposed to just one or two tranches of bond debt, for example, out of court restructurings will be difficult," points out Thomas J. Salerno, co-chair of the international financial restructuring practice at Squire Sanders & Dempsey LLP. "That said, companies with overleveraged but sound core businesses will be able to accomplish restructurings outside of Chapter 11, primarily because the lenders will have more control outside the formal process than in formal processes." Informal restructuring is usually more desirable, although a debtor may be forced into court-directed processes to take advantage of the voting rules under bankruptcy legislation or to acquire debtor-in-possession (DIP) financing.

Creditor approval

Practitioners have known for years that commencing a filing early is helpful in restructurings and markedly improves the chances of success. Pre-filing consensus has always been a key issue for a company hoping to emerge successfully from a bankruptcy proceeding – but never more than now. "Battles between creditor groups never help the restructuring process but when liquidity is more available and excess collateral values perhaps more certain, such consensus is less critical than when everything is tight, which it is in the current market," says Mr Schnelling.

Achieving consensus among creditors is arguably even more important under Canadian restructuring legislation, since it does not contain the same 'cram-down' provisions detailed in the US Bankruptcy Code. "Since a restructuring plan must achieve approval of the requisite majority of creditors in order to succeed, a company must consider this carefully when determining whether it can develop a viable restructuring plan that will ultimately be accepted by its creditors," says Ms D.J. Miller. "If a company fails to consider this, it will be faced with a motion brought early in the proceeding to terminate the restructuring on the basis that it is 'doomed to fail'. This would be the case if the opposing creditor constitutes a blocking vote due to the sheer size of its claim relative to other creditors." She adds, however, that failure to secure the approval of a major creditor in the early stages of a restructuring may not prevent a successful restructuring. There have been cases where creditors rejected proposed terms of an initial plan but after long and intensive negotiations, perhaps with some modifications, finally agreed to support it.

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Future trends

Since the Bankruptcy Abuse Protection and Consumer Protection Act (BAPCPA) changes have come into effect, there has been a slight increase in Section 363 sales. This is largely due to the shorter time periods involved in the restructuring process. "The amendments to the US Bankruptcy Law in 2005 clearly make it more difficult to pursue traditional Chapter 11 objectives. The prevalence of secured creditors with extensive remedial rights who also may control DIP financing puts more pressure on debtors to abandon reorganisation in favour of expeditious sale of the debtors' assets. This is often mandated as part of the post-Chapter 11 financing, as was the case with Tower Records," observes Mr H.R. Miller. But BAPCPA amendments are not entirely to blame for the increase in sales: the nature of the case also contributes. For example, there has been a rise in real estate cases, which are difficult to reorganise at any time in the economic cycle.

As for the pending changes to Canadian insolvency laws, it is unlikely that they will have a material impact on the ratio of sales to restructurings. Court receivership was popular until a few years ago, but a recent spate of unfavourable outcomes, resulting from receiver liability for employee claims, has caused it to fall out of favour. Furthermore, the decision regarding whether to restructure or sell generally lies with the secured class of creditors. Nowadays, there is so much secured debt that creditors may find it easier to leave the company in the hands of existing debtors.

Despite differences in the respective insolvency laws of Canada and the US, interaction and co-operation between the two nations looks promising for the future. "There has historically been very good cross-border co-operation between Canada and the US, with numerous cases such as Laidlaw and others helping to pave the way for future cases," says Mr Salerno. "The shared common law backgrounds and close physical proximity, are also factors. The case by case protocols developed and used in cases, have worked well and will likely continue to do so." However, Chapter 15 of the US Bankruptcy Code has slightly restricted the level of co-operation by reducing the flexibility contained in former section 304. This may result in more Chapter 11 cases. A similar effect is likely to be felt in Canada, but in reverse, when its reforms come into force.

Although the North American market has not yet seen a significant increase in cases, it is clear that a wave of insolvencies and restructurings is about to hit the shore. All the macroeconomic indicators suggest it, and the attitude that banks and other financial institutions have taken to risk since the credit crunch began compounds the trend. Those companies that managed to take advantage of favourable lending conditions during the boom period will not be safe indefinitely. They may be able to limit themselves to an informal restructuring, but if conditions prevail, it seems likely that Chapter 11s and Section 363 sales are a more likely option. It is unclear from this vantage point as to which will be more popular, particularly when the market and legislative background are in flux, but commentators are confident that both countries are structurally strong enough, individually and as a unit, to weather the storm. ■

CHALLENGES IN BANKRUPTCY & RESTRUCTURING

The examiner in corporate restructurings – burden or benefit?

BY ANTHONY H. N. SCHNELLING AND THOMAS J. SALERNO

As the credit market meltdown crashes over the US and international economies, the next major wave of corporate restructurings is in the queue, ready to go. With few remaining sources of readily available capital, and with the aggressive tactics of the hedge and distressed debt funds in restructuring cases, the next round of corporate restructurings promises to be contentious. In addition, questionable activities undertaken by some corporate management to disguise underperformance will undoubtedly be revealed in the blinding light that is the crucible of bankruptcy. There will be no shortage of finger pointing in this exercise.

Enter the examiner

A recent trend in corporate restructurings is the use of examiners. An examiner represents a middle ground between the debtor-in-possession management and a trustee in Chapter 11 cases. The legal standard for appointing an examiner is found in Bankruptcy Code 1104, which provides for the appointment of an examiner upon request of a party or the US Trustee to conduct investigations into the debtor's operations, at the court's direction, into such issues as allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor. Appointment of an examiner is mandatory if either the debtor's fixed, liquidated unsecured debts (other than debts for goods, services or taxes or those owing to an insider) exceeds $5m, or such an appointment is in the best interest of creditors, any equity securityholders and other interests of the estate.

Areas of inquiry for examiners have been varied. Examiners have been appointed and tasked with doing investigations to evaluate: (i) whether a debtor's employment of a consultant was appropriate; (ii) causes of action available to the estate; (iii) the reasonableness of real estate broker fees; (iv) the proper interest rates of claims under a plan; (v) allegations of pre-bankruptcy fraud, dishonesty and other potential improprieties by management; (vi) complex tax issue; (vii) the proposed sale of debtor's assets outside of a plan; (viii) the condition of the debtor's real estate; (ix) the propriety of the debtor and outside lenders with respect to so-called off-balance sheet financings; and (x) whether a board properly discharged its fiduciary duties regarding restructuring proposals.

While the Bankruptcy Code talks in mandatory terms (the court 'shall' appoint an examiner if the one of the two conditions is met), in fact there is a gaping hole in practice. While appointment of examiners may be mandatory, the bankruptcy court retains wide discretion as to what duties are given to the examiner. For example, in a very recent order entered in the Chapter 11 of mining conglomerate ASARCO, LLC in Corpus Christi, Texas, the bankruptcy judge was faced with a motion for appointment of an examiner filed by ASARCO's parent based upon the mandatory debt amounts in the Bankruptcy Code. The parent company, itself the target of fraudulent conveyance and other attacks, asked the court to appoint an examiner to: (i) investigate the good faith of the ongoing plan negotiations among ASARCO and certain other constituents; (ii) conduct a valuation of the debtors; (iii) investigate the good faith of the settlements of claims reached by ASARCO with asbestos claimants; and (iv) investigate whether ASARCO has been properly fulfilling its fiduciary duties to the parent. It is abundantly clear from reading the judge's order that he was not happy with that request. Accordingly, while he ordered the appointment of the examiner, he further ordered that "the examiner shall not have any current duties". While the ASARCO examiner order is certainly an audacious exercise of judicial discretion, it highlights the issue pointedly. In other cases, there is much negotiating and/or litigation over the scope of the examiner duties in such cases. For example, in the Chapter 11 proceeding of Dexter Distributing Corporation in Arizona, after much haggling, between the parties, the bankruptcy judge finally outlined 13 areas of specific inquiry for the examiner in that case.

While the ultimate decision under the Bankruptcy Code is left to the discretion of the US Trustee's office (which actually appoints the person to be the examiner), the US Trustee usually consults with the parties in the case to determine who would be a good candidate. The identity of the actual examiner usually depends upon the issues to be investigated. To the extent they are primarily legal in nature, examiners tend to be lawyers. To the extent they are financial, financial advisers and accountants are frequently used. To the extent the investigation involves operational issues or other specialised issues, turnaround consultants and other experts are brought in. Examiners have the right to retain lawyers and financial advisers to assist in their investigation, and almost always do. Those professionals, along with the fees and costs of the examiner him or herself, constitute administrative claims of the bankruptcy estate. The compensation for examiners, unlike trustees which is set by statute, is a matter of negotiation and can be anything from an hourly rate to a set fee.

In order to address the concern that the examiner might find impropriety in order to get another job – that is, the trustee position – the Bankruptcy Code provides that anyone who acts as an examiner in the case is not eligible, as a matter of law, to serve as a trustee subsequently appointed.

A veritable certainty with respect to an examiner is that someone will likely not be happy with the examiner's report and conclusions – this is particularly true in instances where the examiner is asked to look at allegations of misconduct or breaches of duty. The spectre of being sued looms large. The bankruptcy law provides that examiners enjoy quasi-judicial immunity, thereby insulating themselves for anything other than intentional misconduct or malfeasance.

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To 'seal' or not to 'seal' – that is the question

It has become common practice in reorganisation cases that an examiner report, once issued, is filed under 'seal'. This means simply that the report is filed but it is not accessible in the normal public records of the Bankruptcy Court. This is a clear exception to the general rule that all filings in bankruptcy cases are open to the public. The usual protocol is for the examiner to file a motion with the court requesting permission to file the report under seal. The court will generally order this with the proviso that it is without prejudice of any party to seek to have the report made public. If a matter is kept under 'seal', its use in the case is significantly limited since it cannot be attached to pleadings (although it can be referred to), and its use is otherwise awkward. Accordingly, it is also common for the party who wishes to use the examiner report to ask the court to make the report public. The party whose ox was gored in the examiner report will generally seek to keep the report sealed so it does not become public. Hence, the next wave of litigation begins.

In order to keep an examiner report under seal, the parties seeking to do so must establish either that the report contains confidential or trade secrets type of information, or alternatively that the report needs to remained sealed in order to "protect a person with respect to scandalous or defamatory matter contained in [the examiner report]." (See Bankruptcy Code 107(b)(1), (2); Bankruptcy Rule 9018.) The circumstances where a report is deemed to contain confidential or trade secret information is usually not that contentious. Courts can, for example, opt to redact those aspects of the report that might disclose such confidential information, or may opt to keep the entire report under seal.

The area which generates more controversy is the alternative standard regarding potentially defamatory and scandalous materials. The Bankruptcy Code and rules do not provide any definition of what exactly is 'defamatory' or 'scandalous.' In the cases that have looked at this, the courts are clear that because this is an exception to the presumption that matters filed in bankruptcy court should remain available to the public, the party asserting this must show that the material at issue would alter the effected party's reputation in the eyes of a reasonable person, *and* that the material is untrue or potentially untrue *and* irrelevant or included for an improper end. It is apparent that it is difficult to meet this standard if one was trying to keep an examiner report private. Even if it can be shown that the material at issue would damage a person's reputation, and that the material was untrue or potentially untrue, to the extent that its inclusion in the examiner report was relevant to the examiner's conclusion (even if the effected person vehemently disagreed with the examiner's conclusions or findings), the report would be made public. It is clear that keeping an examiner report from the public arena is, at best, a difficult challenge.

So how does one use an examiner report?

As discussed below, examiner reports are usually not inexpensive. Examiner reports in commercial cases tend to be quite lengthy and detailed. It is a truism that someone in the case will be happy with an examiner report, and someone will not be happy with the examiner report, depending upon the examiner's conclusions. It is clear from a review of some of the more noteworthy examiner reports that examiners don't pull any punches (nor should they), and the examiner report has created serious vehemence in cases. So how can the examiner report be used in the case? That is an interesting conundrum in practice. Can an examiner report be used as evidence of wrong doing based on the examiner's conclusions? The answer is a resounding maybe.

An examiner report is in the strictest form classic hearsay – it is an out of court statement by the examiner regarding facts and legal conclusion drawn from those facts (again depending upon the mandate of the examiner when appointed). Since it is clear that the examiner report does not bind the court in the case, how does one get an examiner report into evidence? Interestingly, there have been few reported decisions on this very important issue in question. There are at least two theories to get an examiner report into evidence. The first is that the facts being determined would constitute 'investigative findings', and therefore would be an exception to the hearsay rule. So are an examiner's factual findings 'investigative findings' such that they are admissible as evidence in court? Perhaps. At least one court has found that the legal conclusions in an examiner report under no circumstances would meet the hearsay exception of the rules, but rather the factual findings may qualify. The problem may be further exasperated by the fact that examiner reports may contain 'hearsay within hearsay.' For example, an examiner report will usually be based upon witness interviews. The examiner may say, for example: "John Doe told me as follows..." Accordingly, not only is the examiner report hearsay, but it contains hearsay with respect to the statement of John Doe. Courts that have looked at this problem have held that unless there is an independent basis in the evidentiary rules to admit the hearsay contained in the examiner report, even the factual findings may be kept out of an evidentiary record.

The second theory used is that the examiner is in the nature of a court-appointed expert under Federal Rule of Evidence 706. Under the Federal Rules of Evidence, a court can appoint its own expert to assist the court with certain defined areas. It has been suggested in at least one case that an examiner is in the nature of a court-appointed expert on the areas that he or she is examining. While that is fine as far as it goes, that would also subject the examiner to complete discovery obligations that would be incumbent upon any expert (such as depositions, requests for production of documents, etc.). This may run counter to the examiner's wishes as the examiner may not simply wish to become an expert for a litigant in the case. (In the Enron case, for example, in order not to 'chill' the examiner's activities, the bankruptcy court specifically limited discovery of the examiner.) In addition, if it is not stated clearly at the outset of the appointment that the examiner will be in the nature of a court-appointed expert, trying to anoint the examiner with this title after the examiner report comes out may be a bit strained.

The cost / benefit analysis for examiners

In contentious cases, examiners and the discharge of their duties can come with a hefty price tag. For example, in the Fibermark case, the examiner report costs the estate $1.75m. In the Dexter Distributing case it was $825,000. In the Enron case, the bill exceeded $100m. So if the examiner report is not evidence or binding on the court, is it worth it? At least one bankruptcy court has addressed this head on. As the bankruptcy court in the Fibermark decision opined, the report is still a benefit to the estate because it provides a 'road map' for parties to follow in the case and otherwise provides an objective and independent view with respect to rights and liabilities of parties. The fact that an examiner's report may be more of a beginning rather than a conclusion was not deemed to be the issue as far as benefit. It is hoped that an examiner report can spur parties to settlement discussions.

We believe the use of examiners in contentious cases in the next wave of corporate restructurings is a certainty. How effective a tool it will prove to be is still an open question. ■

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