

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. Schnellling, 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 ThorntonGroutFinnigan 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

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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 com-

mencing 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.

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. ■