Tectonic Changes Impact Evolving Turnaround Industry

BY JEFF POMERANTZ, SHAREHOLDER, PACHULSKI STANG ZIEHL & JONES LLP

All industries develop over time, as they must, if they are to remain relevant. The turnaround industry is no different, and during the last decade it has evolved to adjust to new legislation, new participants, new investment vehicles, and the collapse of the banking system that led to the Great Recession.

The legislative impact involved, among other things, the most sweeping changes to the U.S. Bankruptcy Code since 1984. A few short years after the 2005 amendments became effective, the banking system experienced a historic collapse that shocked the global economy and triggered the Great Recession. While these changes impacted not only the requirements for, and complexity of, a successful restructuring, they also greatly affected the volume of corporate restructurings. Over time and in the aggregate, all of these changes have significantly changed the landscape of the turnaround industry.

Few predicted that the banking industry would collapse or that interest rates would be so low for so long. Some type of bankruptcy reform favoring creditors was predictable, but the degree to which the specific reforms hindered reorganization, especially in retail cases, was surprising and unintended. Likewise, the continued growth of hedge fund involvement in turnaround situations was predictable, but the extent to which traditional lenders would be supplanted, the level of hedge fund activism, and the dramatic impact of expanded junior debt financing were less expected.

Over time, the accrual of these changes has had a profound effect on the dynamics of corporate reorganizations. While there is significant debate regarding whether these changes have been beneficial, the current restructuring environment is vastly different from what it was a decade ago.

That the traditional Chapter 11 reorganization case is on the decline is not news. In fact, the number of Chapter 11 filings during this century has never reached the rate of the early 1990s. But when one focuses on the current decade in particular, while the numbers of Chapter 11 filings over the last several years have tapered off from the recessionary highs of 2008-2010, which hit 13,683 filings in 2009, they are still an improvement from 2005-2007—in particular, the historic low of 4,643 Chapter 11 filings in 2006. In contrast, 2012 saw 8,900 Chapter 11 filings, 2013 saw 7,660, and the Executive Office for United States Trustees reported 3,477 2014 Chapter 11 filings through the second quarter.

Perhaps more telling is the number of filings by public companies (and the subset of large public companies), which fluctuated from 383 in 2001 (97 of which were large corporations) down to a low of 77 (14) in 2006 before increasing to a modern peak of 255 (91) in 2009 and then falling to 119 (24) in 2012. Notably, however, only 13 large public companies filed from October 2013 through August 2014.[1]

As expected, these trends correlate to the economic cycle and in particular the Great Recession, which commenced in 2008. They also correlate to interest rate fluctuations: the prime rate decreased to just short of 5 percent in 2001 and increased to the 7-8 percent range in 2007 before tumbling in 2008 to protracted and historic lows. Currently the prime rate stands at 3.25 percent, its lowest level since 1955.

Growing Role of Hedge Funds

Arguably, the middling economy that the Federal Reserve Bank is attempting to stimulate by maintaining historically low interest rates has much to do with the dwindling number of large company Chapter 11 filings. In a growth environment, lenders have higher interest options and less tolerance for nonperforming loans and are therefore more willing to force companies to reorganize or sell their assets. Conversely, in a recessionary spiral, struggling companies may have little choice but to file for bankruptcy, regardless of whether a lender forces their hand. In this low interest, low growth environment, however, lenders do not have attractive alternative outlets for their capital and, as a result, are less apt to put the screws to struggling companies.

What institutional lenders have been more apt to do, on the other hand, is to sell their debt to hedge funds. The growing role of hedge fund participation in the restructuring industry is one of the most significant developments of this decade, both because of the junior lien financing it has facilitated and in its impact on reorganization dynamics. Hedge fund participation in large Chapter 11 cases has become the norm. One study found hedge fund involvement in approximately 90 percent of all large Chapter 11 cases: as the largest unsecured creditors in 25.1 percent of large Chapter 11 cases, the largest shareholders in 48.5 percent of those cases, the DIP lenders in 9.1 percent of them, and members of creditors' committees in 38.5 percent.[2]

Unquestionably, hedge funds' appetite for acquiring distressed debt has brought unprecedented liquidity to the debt market. In addition, they have greatly expanded the availability and prevalence of second and third lien financing, in the form of junior lien term loans (often structured for sale in institutional debt markets) or high yield bonds. Hedge funds can supply the debt financing that is the key to avoiding the need for a Chapter 11 filing, or they can be the source of critically needed DIP financing.

In many respects the current restructuring environment is comparable to that which existed between 2004 and 2007, characterized by an abundance of financing sources, relaxed lending standards, and unrealistically high valuations. History teaches, however, that it is only a matter of time before market dynamics change, the capital markets contract, interest rates rise, and the level of in-court restructurings rebounds.

From the perspective of many in the turnaround industry, however, the availability of capital to prop up businesses has come at a high cost. The increased complexity of a company's capital structure and the often divergent motives of hedge funds and other creditors create opportunities for manipulation that can dramatically alter the course and dynamics of restructuring efforts. Banks often have incentives to work with a borrower, such as a desire to preserve longstanding relationships, to enhance or preserve their reputational capital, or to minimize portfolio turnover and transaction costs. It is not uncommon now, however, for a traditional lender to sell its debt at a discount to a hedge fund looking to achieve a short-term profit on highly discounted debt by any possible means. A "successful" reorganization may not be a goal for the fund.

Rather, the fund's goal is simply to realize a meaningful return on its invested capital. Indeed, hedge funds may achieve these ends by acquiring and leveraging a blocking position to force an outcome that involves a change of

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ownership or liquidation event, rather than a traditional reorganization that promises, at best, a long-term return.

Often, the hedge fund's interests are at odds not just with the company's but also with those of competing debtholders. The hedge fund may engage in balance sheet arbitrage, short selling unsecured debt and buying long in debt in classes of secured debt they have acquired. If so, driving down the value of unsecured notes would generate a gain for their short position. They may also have acquired credit default swaps that give them a greater interest in the failure of a competing class of debtholders than in maximizing the return to their own class. They may be pursuing a loan-to-own strategy, in which case they may have an interest in the failure of the debtor to achieve favorable financial results or to meet DIP covenants and milestones.

As a result, the turnaround industry today operates in a setting that more often resembles a high stakes investment game than it does a traditional business reorganization. Manipulation and fights between classes of debtholders are often the main event.

Often missing from the fight card are the general unsecured creditors, who fall victim to the overlevered balance sheets that are the inevitable result of the growth in second and third lien financing. Accordingly, there has been a shift in the restructuring paradigm from first lien lenders/unsecured creditors to first lien lenders/junior secured lenders. General unsecured creditors and their committee are often left out in the cold, relegated to attempting to carve out a recovery based primarily (although not solely) on using the committee's leverage to slow down whatever resolution process is being rushed through by the plan supporters.

The market in general unsecured claims has gone through a dramatic change with the proliferation of claims traders, who are active not just in large cases but also in many midmarket cases. This is a mixed blessing from a reorganization perspective. While the greater liquidity in the debt markets has benefited creditors by allowing them to cash out their claims more readily, it has also shifted the focus of many unsecured creditors to their immediate recovery percentage and away from the prospect of a reorganization that might benefit the company and the creditor in the longer term. Furthermore, those that sell their claims are replaced by traders focused on short-term recoveries, which can be expected to create a liquidation bias.

Typically, the resolution process that the committee is attempting to slow down is the filing upon case commencement of a prearranged plan of reorganization (or de facto liquidation plan) that provides little or no return to unsecured creditors. Effectively, the purpose and effect of these bankruptcy cases is to give Bankruptcy Court blessing to a merger and acquisitions transaction, either in the form a Section 363 sale or a debt-for-equity conversion, to insulate the new owners from prepetition claims.

The plan support agreement among the major stakeholders (unsecured creditors excepted) contains strict covenants and rapid milestones intended to stifle any effort by the unsecured creditors' committee to punch holes in the various all-encompassing liens that the debtor has freely conceded are unassailable. While there is nothing new about debt-for-equity conversions and prepackaged plans have been around for a couple of decades, the modern day debtor equity conversion is an attempt to flush legacy debt as opposed to unimpairing unsecured creditors, which historically was the norm in prepackaged plans.

Interestingly, one large statistical analysis found that hedge fund involvement increased the odds of emergence from bankruptcy and that the success of hedge funds in achieving higher returns on their debt and equity investments "does not come at the expense of other claimants, but rather from creating value for the firm as a whole."[3] The study's authors found that hedge fund involvement was positively associated with: (a) a higher probability of emergence; (b) more deviations from the absolute priority rule; (c) loss of exclusivity; and (d) CEO turnover and adoption of key employee retention plans (KERPs).

The study's statistical analysis did not show decreased returns to unsecured creditors, and so the authors posited that hedge funds were creating value, perhaps by overcoming secured creditors' liquidation bias (hence the higher probability of emergence), by confronting underperforming managers (hence the higher CEO turnover rate and higher probability of loss of exclusivity), by retaining key personnel (reflected in the more frequent adoption of KERPs), and by relaxing financial constraints (as part of a loan-to-own strategy).[4] Many turnaround professionals would question these assumptions and find that the conclusions run counter to their experience based on anecdotal evidence.

One less cynical objective of preplanned Chapter 11 filings is to shorten case duration and so minimize the substantial costs associated with prolonged reorganization cases. The evidence suggests that these efforts have been moderately successful. Data from the UCLA-LoPucki Bankruptcy Research Database shows the average duration of a non-prepackaged, non-prenegotiated large company bankruptcy (from petition date to final decree) in which a plan was confirmed was 651 days for cases concluded during 2013; in contrast, the mean duration of a bankruptcy for a large public company filed with a prenegotiated plan during 2005-2013 was 247 days.[5]

Anecdotal evidence that prearranged plans have increasingly become the norm was corroborated in a recent study that concluded that large Chapter 11 cases filed at the end of 2012 were expected to reach resolution 25 percent faster than those that were filed at the beginning of 2008. The decrease was attributed to the increased percentage of preplanned cases, from less than 40 percent of the 2008 cases to over 60 percent of the 2012 cases. Interestingly, however, the study found that typical free-fall cases filed in late 2012 were projected to take approximately 13 percent longer (49 more days) to reach resolution.[6]

Jeff Pomerantz is a member of Pachulski Stang Ziehl and Jones' management committee, resident in the firm's Los Angeles office. He represents companies, creditors' committees, and private equity funds in complex financial restructurings and merger and acquisition transactions, and is a member of the American Bankruptcy Institute's Executive Committee. Pomerantz holds a bachelor's degree and a law degree from New York University.

*The author wishes to thank his colleague **Harry Hochman** of Pachulski Stang Ziehl & Jones for his assistance in the preparation of this article.*

There has been a general trend during the last decade toward Section 363 sales of all or substantially all assets rather than reorganization as the central resolution event in large Chapter 11 cases. LoPucki reports that for the six-year period from 1997 through 2002, the percentage of large public company bankruptcies that resulted in Section 363 sales exceeded 14 percent only once. In contrast, in 2013, 34 percent of large case filings resulted in Section 363 sales. In all but three of the 11 years since 2003, the rate has exceeded 25 percent.[7]

Another change in the nature of bankruptcy cases in recent years is the dearth of retail reorganizations. Much has been written about the impact of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) on retail bankruptcies. In particular, the creation of Section 503(b)(9) administrative priority status for inventory received within 20 days of the filing and the limitations on extensions of time to assume or reject a retailer's all-important store leases have constrained liquidity and greatly increased time pressures, creating structural barriers to reorganization.

These constraints on a retail debtor's ability to reorganize are exacerbated by the increased liquidation bias of lenders fearful about devaluation of their collateral if inventory is not liquidated within the 210 days that retailers have to assume or reject their store leases. LoPucki reports that retail bankruptcies fell from 14 percent to 9 percent of all bankruptcies after BAPCPA went into effect on October 17, 2005.[8] Ironically, retail companies, which historically were the quintessential candidates for successful reorganizations in Chapter 11, have vanished from the restructuring landscape, leaving going-out-of-business (GOB) sales and expedited 363 sales in their wake.

Addressing the Changes

The modern Bankruptcy Code was drafted in 1978 and has been the subject of patchwork amendments over the past 35 years, primarily as the result of legislation sponsored by special interests. The Bankruptcy Code, however, has not kept pace with developments that have altered the landscape of the restructuring industry, including the expansion of secured credit and the growth of the distressed-debt markets. The result is that the focus of the restructuring process has become more about making money for participants and investors than it is about ensuring a company's long-term survival, which has led to increased acrimony and administrative costs.

What has been lost in the process, perhaps permanently, is consensual efforts to rehabilitate businesses through the cooperative efforts of stakeholders invested in the success of the enterprise. Whether one views the evolution as reflecting a more efficient market for the deployment of resources or a hijacking of the restructuring process, most would agree that the current version of the Bankruptcy Code is ill-equipped to address the tectonic changes that have occurred in the industry.

Accordingly, two years ago the American Bankruptcy Institute (ABI) established a commission of respected practitioners, financial advisors, and academics to study and propose reforms to Chapter 11 and related statutory provisions to better balance the goals of an effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders.[9] The ABI Commission to Study the Reform of Chapter 11 is now in its deliberative phase, with a final report, due in December, that is eagerly awaited by the restructuring community and Congress. ■

[1] Large public company filings reported in the UCLA-LoPucki Bankruptcy Research Database (reproduced by permission), and distilled in the impressive study undertaken by Edward I. Altman in "The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations," published in the Winter 2014 *ABI Law Review* (Vol. 22:75).

[2] Wei Jiang, Kai Li, and Wei Wang, "Hedge Funds and Chapter 11," *Journal of Finance*, Volume 67, Issue 2 (Apr 2012). The authors found the most active funds to be Oaktree Capital Management, Cerberus Capital Management, Loomis Sayles & Co., Appaloosa Management, and PPM America Special Investments Fund.

[3] Wei Jiang, Kai Li, and Wei Wang, "Hedge Funds and Chapter 11," *Journal of Finance*, Volume 67, Issue 2 (Apr 2012), 513–560. The authors drew data from the 500 largest Chapter 11 cases from 1996 to 2007.

[4] *Id.*

[5] UCLA-LoPucki Bankruptcy Research Database (reproduced by permission); Altman, Edward I., "The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations," published in the Winter 2014 *ABI Law Review* (Vol. 22:75).

[6] Dennis A. Meloro, Randall G. Reese and Travis K. Vandell, "The Fast and Laborious: Chapter 11 Case Trends," *ABI Journal*, March 2014 (discussing a study conducted by UpShot Services and Chapter 11 Dockets of voluntary Chapter 11 filings from Jan. 1, 2008, to Dec. 31, 2012, of companies with assets of over $250 million).

[7] UCLA-LoPucki Bankruptcy Research Database. Reproduced by permission.

[8] UCLA-LoPucki Bankruptcy Research Database. Reproduced by permission.

[9] ABI Commission to Study the Reform of Chapter 11, Mission Statement.