The Restructuring Review of the Americas 2019

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The Restructuring Review of the Americas 2019

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Global Restructuring Review is a leading source of news and insight on cross-border restructuring and insolvency law and practice, read by international lawyers, insolvency practitioners and accountants, judges, corporate counsel, investors and academics.

We deliver on-point daily news, surveys and features that give our subscribers the most readable updates and analysis of all the cross-border developments that matter, allowing them to stay on top of their game even more so than they already are.

In the past couple of years, we have published exclusive interviews with bankruptcy judges around the world, unearthed nuggets from court hearings that other news services missed, released several original surveys – including on the experiences of female professionals working in restructuring – and features such as a comparative study looking at current restructuring strategies in the retail sector. Our newly introduced Worked Out series, profiling key jurisdictions around the world, has so far published profiles on Singapore, Ukraine and Delaware, with the Cayman Islands, Hong Kong and China still to come. Our book-length *Art of the Ad Hoc* guide gathers the wisdom and perspectives of some of the leading practitioners in the area of ad hoc committees in restructurings.

Complementing our news and magazine coverage, *The Restructuring Review of the Americas* provides exclusive thought leadership, direct from pre-eminent practitioners. The *Review* gathers the expertise of 19 leading figures from 12 different firms in eight jurisdictions. Contributors are vetted for international standing and knowledge of complex issues before being approached.

In this volume we have expanded our coverage in the United States. In addition to an overview of Chapter 11 of the US Bankruptcy Code, our expert panel also reviews hedge fund and private equity fund participation and some of the investment strategies that funds continue to adopt to maximise their returns. Chapter 15 is discussed in two chapters: first, a full review of Chapter 15 as a tool providing effective mechanisms for dealing with cross-border insolvency cases and looking at whether it remains a welcoming destination for foreign debtors; second, a look at the limits of Chapter 15 with specific consideration to the high burden parties must overcome to invoke section 1506 of the Bankruptcy Code, which allows courts to refuse to take action on public policy grounds.

Furthermore, our panel provides an overview of the bankruptcy law in Argentina and considers criticisms made against Brazil's restructuring legislation and the proposed amendments suggested in May 2018 to revamp corporate restructuring in the country. We also review the broad and flexible restructuring options available in Canada; offshore restructuring in the Bahamas; and the Concurso Law in Mexico, explaining why it has not provided a feasible and efficient restructuring procedure for companies in financial distress. Additionally, our experts in Chile consider the flaws of the local regime, while our panel in Venezuela assesses the current regime, which lacks a statutory concept of insolvency, in the face of widespread economic instability.

The *Review* is annual and will expand with each edition. If you have a suggestion for a topic to cover or would just like to find out how to contribute please contact mahnaz.arta@globalrestructuringreview.com.

GRR would like to thank all our contributors for their time and effort.

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US – New Strategies for Getting Paid: Recent Investment Fund Activity in Chapter 11

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Hedge fund and private equity fund participation in US bankruptcy cases has proliferated in the past decade. Funds specialising in distressed investments now appear in almost every large Chapter 11 case, and often play a significant role in shaping the course and outcome of the case. This trend shows no signs of stopping, despite an improving global economy that has both eased financing constraints and reduced the number of distressed investment opportunities. Instead, investment funds continue to be a strong force in Chapter 11 cases, as sophisticated investors who are adept at finding creative ways to maximise their returns. This chapter examines some of the investment strategies that funds have deployed in response to current market conditions.

Background

The global financial crisis that began in September 2008 precipitated a huge increase in Chapter 11 filings: nearly 20 times more debt was restructured through Chapter 11 in 2008 and 2009 than in the two preceding years.[1] Not only did the total number of filings increase, but the size and complexity of companies seeking bankruptcy protection also grew considerably. Yet this unprecedented upswing occurred at a time when banks and other traditional lenders were themselves struggling with the impacts of the financial crisis (and, later, with the regulatory repercussions that significantly scaled back their ability to invest in distressed situations). Non-traditional lenders, such as investment funds – both private equity and hedge funds – stepped into the resulting funding gap. Unlike traditional banks, investment funds are subject to significantly less regulatory oversight and reporting obligations. This gives them significantly greater flexibility in their investment strategies, which in the economic downturn meant that they had a greater appetite for and ability to invest in distressed situations.

In the decade since the onset of the financial crisis, investment funds have played diverse and varied roles in Chapter 11 cases. They invest in every level of a debtor's capital structure; they provide financing to fund the case and to fund operations post-emergence; they purchase assets through section 363 sale processes; they engage in constructive negotiations with debtors to implement fully consensual restructurings in record time; and they may stake out positions that require them to employ a full range of litigation tactics.

Of these myriad approaches, two overarching strategies stand out. First, investment funds are increasingly the primary financing source for distressed companies, providing debtor-in-possession (DIP) financing to fund Chapter 11 cases as well as exit financing to fund operations post-bankruptcy. Investing new capital in a distressed company in this manner can yield substantial returns for a fund over a relatively short period of time, as the interest, fees and premiums that are earned on such investments tend to be significant. Moreover, by providing such financing, funds gain substantial leverage and control over the company's direction. In the context of DIP financing, for example, DIP lenders occupy the senior-most position over all other investors in the company and are first in line to be repaid. In this capacity, DIP lenders can exert considerable influence over a Chapter 11 case. Among other methods, DIP lenders typically impose milestones on debtors that set forth the key events that must transpire during the cases – such as the confirmation of a plan of reorganisation or the consummation of a section 363 sale process – and the time frame within which these events must occur. For institutions that are already invested in the company, this level of control and influence can be particularly attractive as a way to protect their existing investment. In fact, in many instances, DIP loans can be structured to improve existing investments.[2]

Second, investment funds increasingly invest throughout the capital structure of distressed companies. In many cases, the presence of well-heeled, sophisticated investment funds facilitates a quick and cost-efficient restructuring, avoiding a prolonged Chapter 11 case and the resulting administrative expenses – most notably, professional fees – and delay that can otherwise materially impair the company's ability to successfully reorganise and the fund's ultimate returns. As a consequence, there has been a noticeable increase in 'pre-arranged' and 'pre-packaged' Chapter 11 cases.[3] In these instances, the terms of a Chapter 11 plan are fully negotiated before the case begins through agreement among the company and its key creditor constituencies – typically, one or more ad hoc groups of investors holding majorities of the company's funded indebtedness – including the group believed to hold the fulcrum security. The company then enters Chapter 11 to implement the negotiated deal in the shortest possible time frame.[4]

At the opposite end of the spectrum, investment funds may choose to invest in more junior levels of a company's capital structure or seek to exploit what they perceive to be a flaw in the company's loan agreements or indentures. These more speculative investments are increasingly popular in slower restructuring markets – like today's market – where distressed investment opportunities are diminished and returns are harder to come by. Generally speaking, realising a return on these types of more speculative investments requires funds to employ litigation tactics. These tactics can be aimed at proving an entitlement in relation to other creditors in the capital structure, or as leverage to obtain outsized recoveries as part of an overall settlement divorced from economic entitlement. While difficult to prove empirically, anecdotally, this practice increases the frequency of restructuring litigation and drives up the overall cost of a restructuring.[5]

Recent developments and trends: backstopped rights offering

A fertile ground for generating returns, particularly in the current restructuring market where investment opportunities are fewer and farther between, is to offer to backstop new money investments, whether in the form of debt (eg, DIP and exit financing) or equity. The latter often takes the form of a rights offering, where existing investors are provided an opportunity to invest in the equity of a company about to emerge from Chapter 11, often at a discount (sometimes a substantial one) to the company's Chapter 11 plan value.

Rights offerings are attractive to companies in Chapter 11 that are otherwise capital-constrained because they offer companies ready access to equity capital without substantial cost. This is owing, in part, to the fact that many such offerings are exempt from registration with the

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Securities and Exchange Commission if certain requirements are met. Moreover, rights offerings are highly flexible financing structures that permit parties to customise both the terms and conditions of the equity issuance as well as the terms of the offering (including the allocation of the right to participate) to best serve the needs of the company or the specific circumstances of the company's Chapter 11 case. As a result, rights can be a valuable form of currency when negotiating creditor recoveries under a proposed plan. For these reasons, rights offerings are exceedingly popular: between January 2015 and December 2017, more than US$5.5 billion was raised by distressed companies through rights offerings.[6]

In addition to providing a company with much-needed equity capital, rights offerings are very attractive to creditors, particularly in the relatively limited distressed investment market of the past few years where investment opportunities have been scarce. A key reason is that rights are usually offered at a significant discount to the assumed value of the reorganised company to encourage participation; while the exact percentage can vary widely from case to case, recent offerings typically utilise a discount of 20 per cent to 25 per cent to plan value. That means investors can often acquire a more significant stake in the reorganised company at an implied 'in the money' valuation. These rights offerings further favour funds with capital to invest, given the dilution that typically occurs through a rights offering.[7] Thus, participation is critical to protecting plan recoveries, with those that participate benefiting at the expense of those that do not.

Investors can further enhance the investment opportunity afforded by a rights offering by agreeing to 'backstop' the offering, which means committing to purchase their pro rata shares along with any unsubscribed shares. This guarantee of the offering's success is of enormous value to the company. As such, acting as a backstop party can prove very lucrative. Backstop parties typically earn fees of between 3 per cent and 7 per cent of the total offering in exchange for their commitments, which can be paid in cash or additional shares.[8] Backstop parties may also obtain a preferred, or overallotment of rights to ensure a minimum participation above their pro rata allocation. In practice, these mechanisms provide backstop parties with enhanced economics that increase the return on their pre-existing investment in the company. These mechanisms also allow the backstop parties an opportunity to increase their ownership stake and, along with that, their voice in the governance of the reorganised company.

Given the substantial value at stake in a backstopped rights offering and the potential for overreach, these arrangements are often subject to challenge. Challenges are often levelled at the reasonableness of the backstop fees, though this can be difficult to establish since the market for these fees varies widely. Other challenges take issue with the need and size of the preferred, or overallotment of shares reserved for the backstop parties. Still other challenges have been made to the seemingly disparate treatment offered to the backstop parties as compared to similarly situated creditors in the same class.[9] Given the paucity of recent distressed investment opportunities in the US, the terms of such backstopped rights offerings increasingly generate litigation.

In the *Peabody Energy* case, for example, the bankruptcy court confirmed a plan that contemplated (i) a US$750 million backstopped rights offering of preferred equity to all eligible holders and (ii) a US$750 million private placement of such equity that was offered only to the backstop parties, over the objection of certain non-participating creditors who argued that the plan discriminated unfairly against creditors that were not backstop parties. The court found that the fees and premiums provided to the backstop parties – including the separate private placement as well as the allocation mechanisms therein – were permissible because they were not on account of the backstop parties' prepetition debt holdings, but were in exchange for their post-petition backstop commitments. As such, section 1123 of the Bankruptcy Code was satisfied because all similarly situated creditors were treated equally because they were given the opportunity to participate in the rights offering.[10]

Furthermore, a recent decision in the *Breitburn Energy* bankruptcy cases confirms that it is the opportunity to participate itself that is valuable, and not the creditors' eventual recovery that matters. In that case, the debtors' plan provided that the sole source of recovery for a particular class of creditors was the opportunity to participate in a US$775 million rights offering; parties that elected not to participate would receive nothing. At confirmation, the court overruled the objection of a creditor who had chosen not to participate in the rights offering, and argued that it was not receiving a similar recovery as other similarly situated creditors who had chosen to participate. As part of a lengthy confirmation ruling, the bankruptcy court concluded that this plan treatment was permissible, because '[s]ection 1123(a)(4) requires equality of treatment, not equality of result. It is satisfied if claimants in the same class have the same opportunity for recovery.'[11]

The creative structuring of backstop commitments and rights offering allocations that heavily favour the company's largest stakeholders (which are the parties most likely to provide a backstop commitment) is a trend that is likely to continue.

Recent developments and trends: bankruptcy litigation and the use of litigation trusts

The increasing use of bankruptcy litigation trusts that are formed under a Chapter 11 plan to pursue litigation post-bankruptcy has provided investment funds with an additional source of recovery and an opportunity to deploy capital.

By way of background, post-confirmation litigation trusts are commonly used when debtors have significant litigation claims against third parties, the resolution of which is not required for the company to emerge from Chapter 11. In these cases, the debtor will bequeath the right to pursue these claims to a newly formed litigation trust, and will typically seed the trust with some amount of initial funding. Interests in the trust will then be distributed pro rata to particular creditor groups (typically, junior classes) as part or all of their recovery on account of their prepetition claims. Those interests, which often are freely transferable, entitle the holders to receive their pro rata share of any value that is ultimately obtained through prosecution of these claims.

The preservation of causes of action through litigation trusts is increasingly popular. As one practitioner recently noted, '[i]t is now rare for a plan of reorganisation for a major bankruptcy to be confirmed without the inclusion of a litigation trust as a mechanism to allow the continuation of actions to recover for the creditors.'[12] In large part, this is because the creation of a litigation trust enables a debtor to emerge promptly from Chapter 11, notwithstanding one or more large unresolved litigation claims. Litigation trusts can also be advantageous for creditors that perceive value in the litigation claims and are willing to incur the risks and delays associated with litigation. Traditionally, junior creditors have been more likely to accept those risks in order to obtain a potentially larger overall recovery. Increasingly, however, investment funds have shown both a willingness to receive a stake in a litigation trust as part of their overall recovery under the plan and to finance the underlying litigation.

The *Paragon Offshore* bankruptcy cases provide a recent example. There, the debtors possessed litigation claims against their former parent company, Noble Corporation, which represented a major potential source of recovery for creditors. Initially, the debtors had proposed a Chapter 11 plan premised on settling these claims. This plan eventually gave way to one that preserved those claims for creditors and placed them into a litigation trust. Notably, the interests in that litigation trust were granted not just to junior creditors of the company, but also to secured creditors. In fact, the trust interest proved to be a valuable medium through which to resolve disputes between the secured and unsecured creditors.[13]

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The increasing use of litigation trusts in bankruptcy has afforded investment funds with other investment opportunities as well – specifically, in the area of financing. Typically, the debtors' plan will seed a litigation trust with an initial cash amount when it is formed, after which, the trust is responsible for its funding needs. Increasingly, however, parties have started to experiment with alternative funding structures, including funding from third parties.[14]

One recent case concerns a litigation trust that was established in the 2009 mega bankruptcy filing of General Motors to prosecute certain avoidance actions relating to the company's prepetition term loan. The initial funding for that trust proved insufficient given the size and scope of the litigation, which led the trust administrator to conduct a competitive marketing process to obtain additional funding. Through this process, the trust received two funding proposals: under the first, an investment fund proposed to loan US$15 million to the trust in exchange for up to 4.75 per cent of the eventual proceeds of the litigation; under the second, the company's DIP lenders proposed to loan US$15 million to the trust in exchange for 30 per cent of the eventual proceeds of the litigation as part of a larger settlement. The trust chose the second option, notwithstanding the apparently higher cost of the loan, because of the benefits to unsecured creditors resulting from the overall settlement.[15] This decision was approved by the bankruptcy court, and affirmed on appeal, over the objection of the proposed third-party investor.[16]

Conclusion

Investment funds continue to play a significant role in Chapter 11. They are flexible, sophisticated investors that are able to adapt quickly to changing market conditions to find new ways to deploy capital and maximise their investments. In the most prominent of these recent trends, investment funds have found increasingly creative ways to achieve short-term gains through new investments in distressed companies while at the same time positioning themselves to obtain longer-term pay-offs. In achieving these goals, investment funds adapt existing tactics and strategies to new situations and new aspects of Chapter 11 practice. The new developments discussed herein offer excellent examples of the creativity and flexibility that can mark investment fund activity in distressed situations.

Notes

1 Stuart Gilson, Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry are Helping to Revive the U.S. Economy, 24 *J Applied Corp Fin* 23, 23 (2012).

2 One common example is known as a 'roll-up', where the new funds advanced as part of the DIP financing are used to repay prepetition loans. See *In re Capmark Fin Gp Inc*, 438 BR 471, 511 (Bankr D Del 2010) ('Roll-ups most commonly arise where a pre-petition secured creditor is also providing a post-petition DIP loan. . . . The proceeds of the DIP loan are used to pay off or replace the pre-petition debt, resulting in a post-petition debt equal to the pre-petition debt plus any new money being lent to the debtor. As a result, the entirety of the pre-petition and post-petition debt enjoys the post-petition protection of section 364(c) and/or (d) as well as the terms of the DIP order.').

3 In 2003, only 6 per cent of large companies entered Chapter 11 with a pre-negotiated plan; in 2017, 42 per cent of all Chapter 11 filings by large companies (with assets of more than US$500 million) were pre-packaged. This has had a significant impact on the duration of Chapter 11 cases overall. For Chapter 11 cases confirmed in 2017, the median length of the case was only four months. See Norman Kinel, The Ever-Shrinking Chapter 11 Case, *Nat'l L Rev* (20 August 2018) (discussing 7 August 2018 report by Fitch Ratings).

4 In a 'pre-packaged' case (as compared to a 'pre-arranged' one), the parties have taken the additional step of soliciting votes on that plan before filing. In these instances, the company does not need to spend time in Chapter 11 engaged in solicitation; instead, the company moves straight to confirmation (ie, approval of the plan), and may be in Chapter 11 for 30–45 days or sometimes even less.

5 But see Jared Ellias, Are Litigious Hedge Funds a Problem? A Study of Activism, 35 AM. *Bankr Inst J* 28 (2016) (an empirical study of cases filed in the years immediately after the financial crisis that found that litigation commenced by funds who had invested in junior debt, so-called 'junior activism', was associated both with an increase in the assumed value of the restructuring transaction and higher recoveries than the market anticipated prior to the process).

6 Jay Goffman and George Howard, Rights Offerings Prove Popular with Both Debtors, Distressed Investors, *J of Corp Renewal* at *5 (January/February 2018).

7 In one recent example, the court approved a plan under which the prepetition noteholder class would receive their pro rata share of 79.5 per cent of the equity in the reorganised debtors on account of their claims. That recovery, however, was subject to significant dilution by convertible notes that were being issued through a backstopped rights offering; upon conversion of the notes, the noteholders' 79.5 per cent equity stake would be diluted down to 11.6 per cent of the total equity. *In re CHC Group Ltd*, Case No. 16-31854 [Dkt No. 1794] (Bankr ND Tex 3 March 2017).

8 See Goffman and Howard, supra note 6.

9 Section 1123(a)(4) of the Bankruptcy Code requires that a Chapter 11 plan provide the same treatment for each class of claims or interests, unless a holder agrees to less favourable treatment.

10 *In re Peabody Energy Corp*, Case No. 16-42529 [Dkt No. 2763] (Bankr ED Mo 30 March 2017); see also *In re CHC Group Ltd*, Case No. 16-31854 [Dkt No. 1794] (Bankr ND Tex 3 March 2017) (confirming plan over objection of non-participating creditor, where plan provided the noteholder class with their pro rata share of 79.5 per cent of the equity of the reorganized company, but recovery was subject to dilution down to 11.6 per cent upon conversion of convertible notes being issued under a backstopped rights offering).

11 *In re Breitburn Energy Partners LP*, 582 BR 321, 358 (Bankr SDNY 2018). Though the court denied confirmation of the plan for reasons unrelated to the rights offering in this decision, the plan was subsequently confirmed after the parties made certain technical modification. See *In re Breitburn Energy*, Case No. 16-11390 [Dkt No. 2387] (Bankr SDNY 26 March 2018) (order confirming modified plan).

12 Jeffrey Pomerantz et al, Bankruptcy Litigation - Roundtable Discussion, *Financier Worldwide Mag* (July 2016) (comments of Timothy Martin).

13 *In re Paragon Offshore PLC*, Case No. 16-10383 (Bankr D Del 2016).The litigation trust subsequently commenced a US$1.7 billion suit against the former parent company, which remains pending. *Paragon Litigation Trust v Noble Corp PLC et al*, Case No. 17-51882 (Bankr D Del 2017).

14 See generally Kenneth Epstein and Eric Fischer, Litigation Funding in Bankruptcy Court: An Essential Tool for Maximizing the Value of the Debtor's Estate, 259 *NYLJ* 50 (2018).

15 By fixing the DIP lenders' percentage recovery at 30 per cent, the settlement resolving a pending dispute between the DIP lenders and general unsecured creditors over their respective entitlements to the proceeds of this litigation. The bankruptcy court found that the terms of the settlement, including the negotiated 70 per cent recovery for unsecured creditors, was reasonable when compared to the cost and uncertainty of litigating this issue. In contrast, the third-party loan did not resolve this dispute, which left the recovery for unsecured creditors unknown.

16 See *In re Motors Liquidation Co*, 2017 WL 3491970, at *9 (SDNY 14 August 2017).

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Deputy chair of the bankruptcy and corporate reorganisation department, Brian focuses on a range of restructuring and bankruptcy matters for both borrower and lender clients. He has extensive experience representing clients in complex out-of-court restructurings and Chapter 11 cases nationwide and across various industries and routinely represents clients in complex litigation arising out of Chapter 11. A member of the media, sports and entertainment group, he also has developed a sub-specialty working on a number of music, media and entertainment company restructurings and related matters.

Brian's recent company experience includes advising Expro Holdings, CGG SA and Preferred Sands, and his noteworthy creditor-side representations include advising key stakeholders in the restructurings of Toys "R" Us, Tidewater, Paragon Offshore, Sabine, Arch Coal, Texas Competitive Electric Holdings Company, Armstrong Energy, Nortek and General Motors.

Brian was named an *American Lawyer* 2018 'Dealmaker of the Year' for his work representing French oilfield services company CGG SA in its Chapter 11 cases, among the largest restructurings in French history and the first-ever successful coordination of a French 'Sauvegarde' proceeding with a US Chapter 11 case. Brian is recognised by *Chambers USA*, *The Legal 500*, *The Best Lawyers in America* and *Super Lawyers*. Clients praise him as 'masterful with his clients and in his strategy', drawing attention to his 'very commercial thinking and very strong technical skill'. He is also recognised as a 'Thought Leader' in restructuring and insolvency by *Who's Who Legal* and is listed as a Featured Dealmaker in *The Deal*.

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Lauren's recent debtor representations include: certain subsidiaries of CGG SA in their pre-negotiated Chapter 11 cases through concurrent restructuring proceedings in France and the United States; Foresight Energy LP, a US thermal coal producer and marketer, and its subsidiaries in connection with an out-of-court restructuring; and Walter Energy, Inc, a leading producer and exporter of metallurgical coal, in all aspects of its Chapter 11 case. Recent noteworthy creditor-side representations include advising: an affiliate of KKR in its acquisition of Angelica Corporation, a Georgia-based provider of textile rental and linen management services to the US healthcare market; an informal noteholder committee and the post-petition lenders of Linc USA GP, a US oil and gas explorer and producer, in the company's prepetition restructuring efforts and subsequent Chapter 11 case; and an informal noteholder committee and the post-petition lenders of Xinergy Corp, a US coal producer, in the company's prepetition restructuring efforts and subsequent Chapter 11 case.

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