FTI CONSULTING

Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

Michael Eisenband
Consulting Editor
FTI Consulting

AMERICAN BANKRUPTCY INSTITUTE

NAVIGATING TODAY'S ENVIRONMENT

THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING

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A BRIEF LOOKBACK AT A DECADE OF RESTRUCTURINGS, DEFAULTS AND LEVERAGED FINANCE

FTI Consulting

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Consulting Editor

The past dozen years of corporate restructuring activity were punctuated by default cycles on each side of the "teens" decade associated with two recessions, a stark reminder that the prospects of our profession remain highly dependent on the vagaries of an economic cycle that is often unpredictable and more often benign than harsh. Moreover, the recessions of 2009 and 2020 that ushered in these two default cycles were triggered by unforeseen "Black Swan" events[1] that kicked off a wave of restructurings across the corporate landscape but subsided far sooner than most expected — much to the surprise of the restructuring profession. Extreme policy responses by the federal government early on in these downturns contributed meaningfully to relatively speedy resolutions, but it is unclear if such aggressive responses can be or should be part of any policy playbook going forward. For the restructuring profession, the "teens" decade was often challenging to navigate, as cyclical events that typically propel spikes in restructuring activity occurred less frequently and were difficult to anticipate and manage through, while global financial markets benefited from unprecedented monetary stimulus from central banks and were more tolerant of aggressive capital structures and debt financing solutions for high risk companies.

Conversely, these were favorable developments for the corporate sector, as the time between cyclical downturns lengthened, earnings momentum persisted longer, new sources of capital became abundant and financial markets were supportive of speculative-grade corporate financing as never before. In turn, most large companies have taken full advantage of these generous conditions — borrowing more aggressively than they have done historically, returning more capital to shareholders, and growing more comfortable using financial leverage to magnify earnings growth. Financial markets have enabled this riskier behavior and have rewarded it as well. However, doing so also leaves businesses more vulnerable to unexpected adverse events, and that is a calculated risk most large companies are willing to assume as we transition further into a new decade that already resembles this century's version of "the Roaring Twenties" with respect to market performance and wealth extravagance. Let's hope it ends better than that notorious decade.

[1] Black Swan events are also known as low probability/high impact events. https://corporatefinanceinstitute.com/resources/knowledge/finance/black-swan-event/

It's impossible to document in a few short pages how extensively the corporate landscape has changed in these last ten years, but we can certainly put some broad strokes on key themes of the last decade.

Central banks' policy responses to financial crises and economic malaise since 2008 helped avert disaster but got financial markets and large businesses hooked on easy money, artificially low interest rates, distorted capital allocations and encouraged risky investment behaviors

Yes, that's a big mouthful to chew on. Without question, central banks' interventions in global markets and highly stimulative monetary policy across the globe have been a dominant economic theme since 2008. The global financial crisis of 2008 caused the Federal Reserve and other major central banks to resort to extremely unconventional and aggressive policy responses, including massive interventions in financial markets and quantitative easing ("QE") monetary policies that drove down interest rates with the intention of stimulating economic activity. The Fed's three QE programs caused the size of its balance sheet to quadruple to $4.5 trillion between 2008 and 2014, when QE3 finally was ended.[2] Fed asset purchases are "paid for" by crediting the reserve accounts of banks selling securities on their own behalf or on behalf client institutions and thus constituted the indirect creation of money, as banks utilized these excess reserves to expand their own balance sheets via lending and other activities.

The Fed's intention to eventually unwind its bloated balance sheet never made much headway, shrinking to $3.8 trillion in 2019 before resuming its ascent. After a brief period of tightening, to which markets reacted furiously, the Fed did an about-face in 2019, and monetary policy again eased, eventually driving riskless interest rates toward zero, causing real interest rates to go negative and driving up market prices across most asset classes. Furthermore, the Fed's stepped-up asset purchase program begun during the COVID-19 pandemic caused its balance sheet to double since late 2019, to nearly $8.9 trillion, an unfathomable size that cannot be unwound to any reasonable degree without causing dislocations across credit markets. Moreover, the Fed's Primary Market and Secondary Market Corporate Credit Facilities introduced during the early months of COVID amounted to its direct intervention in corporate credit markets, an unprecedented move of support that pacified credit markets but created lots of moral hazards in the process, which arguably encouraged more risky lending behaviors.

Huge asset purchase programs by the Fed and other central banks kept global interest rates artificially low for more than a decade, during which time corporations and investment funds were able to borrow cheaply, abundantly and on favorable terms. However, the time to end this grand experiment has arrived. Critics of QE and other stimulative Fed actions have long argued that such policies have been overdone and eventually must be inflationary. (The M-2 measure of the U.S. money supply increased by 25% in 2020 alone, by far the largest annual increase on record,[3] and by 40% since COVID-19 hit through mid-2022.) Such inflationary concerns were misplaced in recent years, and there was little downside to speak of after more than a decade of easy money policies — until recently. Such a benign outcome would upend a bedrock principle of macroeconomics by demonstrating that a prolonged period of aggressive money creation is an action without negative consequences. Ultimately, it would mean there is such a thing as a free lunch. Skeptics abound.

But we're not in the clear. Inflation finally has accelerated sharply since mid-2021 and it's too soon to know how severe or long-lasting it will be. What we do know is: the Fed's $120 billion monthly asset purchase program has ended and a gradual runoff of its huge securities portfolio has begun. Moreover,

[2] https://www.brookings.edu/blog/up-front/2021/07/15/what-does-the-federal-reserve-mean-when-it-talks-about-tapering/

[3] https://fred.stlouisfed.org/series/M2SL

the Fed hiked its targeted Fed Funds rate three times by mid-2022, including two huge 75 bps hikes in June and July, with several smaller hikes expected by year-end to address accelerating inflation and tamp down market excesses. Extensive Fed support that has propped up the national economy and financial markets for over a decade has finally ended. How will they fare without these extraordinary efforts? We're about to find out.

Most large corporations have embraced higher leverage without consequences — so far

It's hard to resist the temptation to borrow more heavily when capital is plentiful and cheap, as it has been for much of the last decade. It has been a mostly borrower-friendly environment ever since the effects of the Great Recession were behind us. We recall hearing the first mentions of the dreaded "maturity wall" back in 2010, as many market watchers anticipated a raft of debt defaults as speculative-grade borrowers would be unable to refinance or rollover a wall of maturing debt once corporate credit markets found discipline again in the aftermath of the Great Recession. A decade later, it still hasn't happened, and the so-called maturity wall default wave scenario has never materialized. Each time a maturity wall approached, generally every four years or so, leveraged credit markets allowed most large borrowers to refinance their impending debt maturities. This has happened several times since 2010 and even today, most speculative-grade companies have managed to push out material debt maturities to 2024-25, with modest maturities scheduled for the next two years. The willingness of leveraged credit markets to let borrowers continuously push out debt maturities and avoid the prospect of refinancing risk or payment default gave rise to some common expressions, such as "kick the can" and "amend & pretend." Anyone expecting that COVID-19 would have finally caused leveraged credit markets to take away the punchbowl was sorely disappointed. On the contrary, leveraged debt issuance soared to record levels from mid-2020 through 2021. a U.S. high-yield bond issuance had its best year ever ***during a pandemic***, topping $400 billion for the first time ever,[4] and then shattered that record in 2021 with some $465 billion of new issuance.

There are fewer strings attached to these borrowings as well. Leveraged term loans that once had maturities rarely exceeding four years now often go out to six or seven years. Covenant-lite loans, which lack maintenance covenants that traditionally give lenders some actionable recourse when a borrower's performance badly sputters, are now prevalent in leveraged loan documentation. This often requires lenders to wait for an event of payment default before having the ability to intervene in a deteriorating credit, and probably lowers recovery rates for creditors in the event of a bankruptcy filing. Refinitiv LPC reports that covenant-lite loans now account for three-quarters of institutional loan tranches and one-half of all syndicated leveraged loans after having virtually disappeared in 2010–2011 following the Great Recession. This development hasn't occurred by happenstance. Borrowers, often private equity-owned companies, have wrested these concessions from lenders, among other negotiated wins in loan documentation. The dominance of CLOs as participants in leveraged loan tranches has contributed to these outcomes. U.S. CLOs now control $925 billion of assets under management, a volume that has more than doubled since 2015, and account for nearly two-thirds of the $1.4 trillion of institutional loans outstanding. Most CLOs are on board with these concessions. Their primary concern is putting capital to work.

Aggressive moves by leveraged borrowers that exploit loose language in credit documents have eroded lender protections in recent years. Such tactics include asset stripping and/or the movement of collateral to unrestricted subsidiaries outside the reach of secured lenders, and a heavy reliance on borrower baskets that often permit these transactions. Ultimately, these are negotiated loan terms in credit documentation, with borrowers

[4] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-high-yield-bond-issuance-crests-400b-for-first-time-blasting-prior-record-61401312

frequently getting concessions from lenders. J Crew and Neiman Marcus are two prominent examples of these maneuvers, but there are many others where these borrower-friendly provisions in loan documents have later resulted in lender-unfriendly transactions. Sponsors want this optionality and have been persistent in pressing for (and often winning) such concessions from lenders who seem unwilling to push back against large sponsor groups.

Acquiescence by traditional lenders on loan underwriting terms and provisions reflect concerns among many lenders that deals might be lost to alternative sources if borrowers' demands aren't met. The ascent of private capital during the past decade gives borrowers choices that didn't exist previously. Alternatives to large syndicated loans, including Business Development Companies ("BDCs") and direct lending and distressed lending funds run by private credit platforms, have become mainstream and provide middle-market and some large corporate borrowers with improved access to capital. Many of the largest private equity managers today also manage credit funds or affiliated BDCs earmarked for leveraged lending. Private credit funds larger than $1 billion aren't unusual these days. Capital raises and dry powder earmarked for leveraged lending are as plentiful as ever.

Given these developments, it's not surprising that leveraged debt outstanding has soared in recent years while credit quality has deteriorated. S&P reports that rated U.S. speculative-grade corporate debt outstanding (loans and bonds) has increased to $3.4 trillion in mid-2021 from $2.4 trillion in 2016, a 42% increase in just five years, including an unprecedented 15% increase year-over-year ("YOY") in 2020. Not only has the amount of junk-rated corporate debt increased in recent years, but it has gotten junkier. S&P notes there are nearly 2,000 U.S. speculative-grade issuers currently compared to 1,400 in. 2011, while the percentage of those issuers rated B- or lower ("deep junk") topped 40% in 2020, an historic high and remains near 35% currently compared to 20% in 2015 and 18% in 2011. Leveraged credit markets remain unphased by this degradation of credit quality in recent years, with market yields on speculative-grade debt touching all-time lows in 2021. That has changed abruptly in 2022, as the end of QE has ushered in higher corporate borrowing rates and plummeting speculative-grade issuance volumes. With a Fed-induced recession possibly on the horizon, it's most likely that more restrictive credit market conditions will persist for a while.

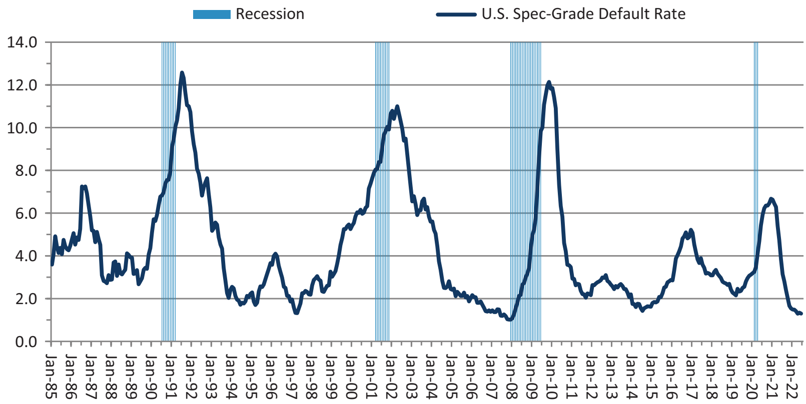
The cumulative impact of leveraged buyout ("LBO") activity has certainly contributed to the decline in credit quality since 2010. U.S. LBO activity roared back to life in 2021 after a pandemic year slump and enjoyed its strongest year in terms of deal count and dollar volume since 2007, the highwater mark for LBO activity. Average LBO deal leverage is at an all-time high of 7X earnings before interest, taxes, depreciation and amortization ("EBITDA") a full turn higher than at mid-decade and two turns higher than deals done in 2010–2011, while the average purchase price multiple is easily at an all-time high of nearly 13X EBITDA, per Refinitiv LPC. Buyout deals leveraged at 6X EBITDA or more were considered outlier deals a decade ago but have since become the norm, with questionable or even dubious add-back adjustments to EBITDA for non-recurring and pro forma adjustments.

Near-record low interest rates and favorable borrowing terms through 2021 made higher relative leverage levels more tolerable, but rock bottom borrowing rates and easy terms cannot persist indefinitely without ongoing central bank intervention in credit markets. Some aggressive borrowers will eventually face a day of reckoning as interest rates begin to normalize towards historical levels and the Fed pivots towards tighter monetary policy. That new policy path has begun.

Bankruptcy filings finished the decade on a high note but faded fast after COVID peaked, while average case length continues its long trend lower

Chapter 11 filings and other restructuring activity typically increase by a factor of 2–3x during a default cycle year compared to an average year, and 2020 fell short of that mark. Filings and defaults did hit

EXHIBIT 1. U.S. speculative-grade default rate (in %)



Source: S&P Global Ratings Research

a decade high during the pandemic year of 2020 but were already on the wane by the time the year ended. Similarly, the previous default cycle of 2009 was rapidly unwinding in 2010 a decade earlier (**Exhibit 1**).

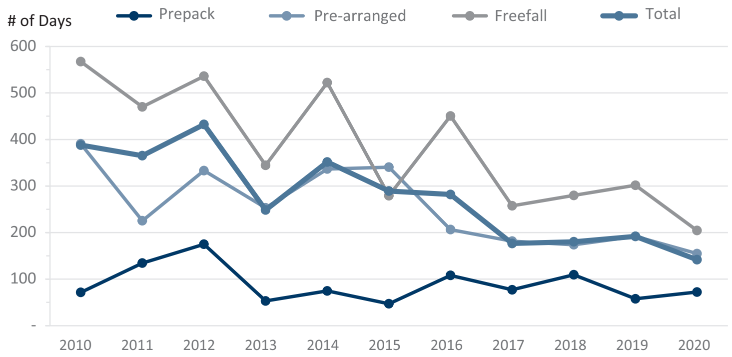
Large business bankruptcy filings and corporate debt defaults had six months of intense activity beginning in March 2020 before abruptly tailing off by the end of that summer when economic recovery became evident, and the flow of corporate credit resumed. This recent default cycle was shorter and less intense than in 2008–2009, with filing and default totals falling short of that previous downturn by about 25%. S&P's speculative-grade default rate peaked at 6.6% in 2020 compared to 12.1% in late 2009 and a typical low double-digit default rate peak during these cycles. Those who were dug in for a prolonged recession and default cycle due to the pandemic were caught flatfooted. The only other flareup of default and filing activity during the past decade was in 2016, when oil prices plunged, and energy-related business failures were rampant. That episode, which did not constitute a true default cycle, was especially brutal for the U.S. energy sector but was mostly contained to the industry and its fallout to the broader business economy was contained.

Ironically, bankruptcy filings by small businesses and individuals plummeted during the pandemic year, as financial relief under the CARES Act and other federal relief programs, including the Paycheck Protection Program and the Small Business Debt Relief Program, quickly made its way to millions of impacted Americans and businesses. Incredibly, bankruptcy filings by individuals hit a 35-year low during a year in which 22 million jobs were lost at the peak of the pandemic. Bankruptcy experts continue to debate whether these many generous relief measures truly averted bankruptcy filings or merely deferred them into the near future once this relief is exhausted.

Restructuring activity spiraled lower in 2021 and early 2022, as pandemic effects subsided, the U.S. economic recovery gained traction and credit markets remained incredibly supportive of speculative-grade borrowers, and it remains subdued through mid-2022. Various measures of restructuring activity were down 50%-70% YOY compared to 2020, depending on the metric, and the year concluded as a disappointing one for the restructuring profession. Most default rate forecasts are in the low 3.0% range by early-to-mid 2023, a sobering reality for those awaiting an overdue comeuppance after a long stretch of aggressive corporate financing decisions and credit market euphoria.

One bankruptcy trend that has persisted for much of the past decade is the steady decline in average case lengths of Chapter 11 filings (**Exhibit 2**),

EXHIBIT 2. Chapter 11 filings: average case length by filing year



Source: The Deal and FTI Consulting analysis

which has been nearly cut in half over the last ten years to approximately 150 days (filing date to exit date) in 2020. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"[5]) imposed limits on the time a debtor could remain in Chapter 11, but average case lengths didn't begin to decline appreciably until after the end of the Great Recession. This noteworthy trend has several underlying causes, all of which have likely contributed to this outcome and are worthy of discussion.

— **Stricter debtor-in-possession financing terms**: Debtor-in-possession ("DIP") financing lenders have imposed stricter terms and conditions on debtors in recent years, giving them greater control over cases in some critical respects and minimizing the risk of collateral dissipation. Such terms typically involve tight event milestones or timelines (such as fixed timeline in which a debtor must file a plan of reorganization or complete an auction process) that debtors must adhere to or risk an event of default. These tight event milestone dates effectively force a debtor to complete its reorganization as expeditiously as possible. Contributing to this outcome, DIP loans increasingly have been provided by private lenders or investors, who may view DIP lending as a means to an end, instead of traditional bank lenders.

— **Large distressed investors can drive outcomes:** Large distressed investors today are extremely opportunistic in identifying situations that meet their investment criteria and can assert themselves into these deals in a big way. Often taking large concentrated or controlling positions within a creditor class or across classes, these investors also team up with other likeminded parties to influence a case outcome and quickly drive its resolution. Meanwhile, large syndicated lenders retaining their positions from loan inception through a restructuring event have become increasingly less frequent.

— **Greater prevalence of pre-packaged and pre-negotiated filings:** Debtors today go to great lengths to avoid a "freefall filing" where formal or informal agreements with key creditor groups and potential DIP lenders are not negotiated or in place in advance of a Chapter 11 filing. It wasn't always that way. Pre-packaged and pre-negotiated filings, which significantly reduce the time a debtor is in Chapter 11 and may increase the likelihood of a successful reorganization, account for a bigger share of large Chapter 11 filings than they did a decade ago. This was especially true in mid-decade, from 2014–2018, when pre-packaged and pre-negotiated filings accounted for a majority of large corporate Chapter 11 filings, though the share of freefall filings has ticked up in the last two years,

[5] https://www.congress.gov/bill/109th-congress/senate-bill/256

especially since COVID-19 struck. Even so, the average case length of a freefall filing has also declined appreciably since 2010 despite the increased complexity of many Chapter 11 cases.

It seems unlikely that the decade ahead for restructuring activity will resemble the last one to any fair degree, as the extraordinary measures taken by state actors to support global economies and financial markets cannot continue indefinitely. Many hundreds of highly leveraged borrowers have left themselves vulnerable not only to big impact events but to any normalization of credit market conditions towards long-term historical norms. Despite two unprecedented shock events in 2008 and 2020 that brought the global economy to the brink of collapse, financial markets and the corporate sector continued to operate in full risk-on mode through 2021 — but no longer.[6]

It has been a dozen years since we first published ***Navigating Today's Environment***, *The Directors' and Officers' Guide to Restructuring*. While little has changed to the Bankruptcy Code itself in that time (other than the addition of Subchapter V, the Small Business Reorganization Act), the novel, aggressive and, at times, controversial application of provisions of the Code to business reorganizations has altered the practical landscape and impacted case outcomes. Consequently, we decided it was the right time to update and republish our handbook to reflect some ways in which the practical application of the Code has changed in the last decade or so. It's especially timely, as large corporate bankruptcy filings seem poised to accelerate sharply following a prolonged COVID-related lull. Bankruptcy law itself may be a static vessel but the creative ways in which debtors, creditors, courts, advisors and other parties-in-interest interpret and apply that law to business events and situations is always evolving and topically relevant to challenged companies confronting difficult choices.

[6] The author would like to acknowledge John Yozzo, Managing Director, for his contributions to this prologue.

1 WHO'S WHO: AN INTRODUCTION FOR OFFICERS AND DIRECTORS TO THE TYPICAL PLAYERS IN A RESTRUCTURING TRANSACTION

LEGAL PERSPECTIVE

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Distress can incapacitate even the most effectively managed operations. Officers and directors who find themselves managing through such distress — no matter its form — can agree on one thing: the learning curve is steep. Restructuring transactions are notoriously complex: they require an understanding of competing and complicated interests across many actors, demand tremendous time and attention from senior management and the board just when such focus is most needed on the business itself, and move quickly, and often, unpredictably. Understanding core foundational principles — the proverbial lay of the land — of the distressed arena may *actually* spell the difference between a company careening off the rails into a value-destructive liquidation and artfully crafting a comprehensive, multiparty transformative restructuring which best ensures its future success.

This chapter provides officers and directors with a basic primer on the typical "players" involved in distressed company transactions. By plainly describing these players — as well as their roles and primary motivations — this chapter seeks to quickly flatten any learning curve faced by officers and directors new to restructuring transactions.

As an initial matter, this chapter addresses both what restructuring professionals call "in-court" restructuring transactions (the most common being a Chapter 11 bankruptcy) as well as "out-of-court" restructuring transactions (e.g., debt-for-equity exchanges, forbearances and refinancings). Indeed, out-of-court transactions have become more common over the years as the sophistication of interested parties has continued to grow. This chapter does not probe distinctions among these transactions or why one structure or strategy may be favored over another (indeed, all of the knowledge contained within the pages of this book can only marginally reach the necessary depth for that audacious goal). However, understanding the key players who are often present when trouble arises, and their directional motivations, can maximize the likelihood that company leaders take the right first steps early in the process.

The company and its professionals

It is impossible to generalize what distressed companies will need from a restructuring transaction because every situation is different. Companies undertake a restructuring process because they are facing some type of stress. The stress may be caused by general economic or industry-wide factors, or circumstances specific to the company, such as liquidity shortfalls, outsized leverage, pending maturities or defaults under its debt or other capital documents. Addressing the underlying issues, whatever they may be, *in an effective manner* is the ultimate goal of the restructuring process. At the same time, the company must also manage other issues that become more acute in restructuring scenarios, such as a desire to implement its business plan, retain and incentivize its management and employees, protect its customer base and manage vendor relations. All of this, of course, falls under the overlay of actually maintaining the effective operations of the company itself.

General managers ("GM"s) of winning professional sports franchises often serve as able research subjects in the quest to identify model executive traits, and for good reason. Like executives, GMs execute the essential role of assembling the right mix of talent and experience for short- and long-term success. This requires understanding the role each player performs and how that performance affects the performance of others. As with executives, the stakes are high: if they fail to understand these dynamics, they will be required to answer questions — from the fans, the press and the owner.

This analogy can be taken a step further once a company becomes distressed: imagine new rules of the game have been introduced, the way you win the game (or what even counts as winning) has changed, and instead of playing against one opponent, several other teams have now also taken to the field, all while the stakes have become higher. Strategies that were once consistent with your fiduciary duties now run afoul of them given the shifting nature of officers' and directors' legal obligations. You see where we are going. Just as an experienced GM would thoughtfully reconsider his or her team's lineup to best confront these new challenges, so might officers and directors of distressed companies thoughtfully consider and retain the right professional advisors to navigate the complexities of their unique distressed situation.

Here, we focus on three of the most essential advisors to a distressed company: legal restructuring counsel, financial advisors and investment bankers.

— **Legal restructuring counsel:** Once a company has identified the need for a potential restructuring transaction — which often may be 6 to 18 months before any restructuring triggering event — directors and officers should begin consulting with experienced legal restructuring counsel. Restructuring lawyers help companies develop a high-level restructuring strategy, and assist in all aspects of implementing that strategy. For example, imagine a company that knows it could face challenges refinancing a bond issuance that matures in 18 months. Lawyers will help advise officers and directors about the benefits and considerations of available strategies, such as using proceeds of an asset sale to pay down liabilities, seeking a waiver or forbearance from key constituency groups or proactively launching an exchange. Once a strategy has been selected, lawyers advise on available execution tactics for implementation. If the strategy requires Chapter 11 (or the threat thereof, which alone can be a powerful tool), then restructuring counsel will help advise the company's management (often on a daily basis) with tasks such as managing liquidity and messaging to key constituents like customers, vendors and employees. Last, but certainly not least, restructuring counsel help companies establish and execute appropriate decision-making processes to minimize litigation risk, including against officers and directors themselves.

— **Financial advisors:** Financial advisors (often referred to as "FA"s) familiar with the restructuring space are extremely valuable to officers and directors of distressed companies. Much like lawyers, FAs often play an essential role in developing and implementing a high-level restructuring strategy. For example, in many out-of-court restructurings, FAs run forecasts to compare the benefits and risks of competing transactions. In Chapter 11 restructurings, they help officers manage liquidity, obtain "debtor-in-possession" financing and provide required reporting to lenders. By integrating into the company's daily operations — often spending significant time on-site — FAs provide tremendous support to senior management. Unsurprisingly, FAs also often work hand in hand with senior management to assess the soundness of the company's material contracts and leases in order to develop an optimized go-forward business plan. In some instances, a company may install a senior FA as a "chief restructuring officer" or similar role.

— **Investment bankers:** Distressed companies often engage restructuring investment bankers. In some cases, investment bankers are tasked with selling the company or certain key assets. In other cases, they help companies access lending and capital markets, and ensure officers and directors have accurate and necessary inputs to understand the company's go-forward prospects (e.g., cost of capital, liquidity, availability of strategic transactions). In addition to helping the board, the insights of investment bankers are often essential components to the advice provided by the company's lawyers and FAs.

Company leadership's ability to successfully craft the right combination of advisors to tackle the particular challenges of a situation often will prove paramount to whether a company is able to navigate the dangerous waters of distress; it will serve as the cornerstone upon which all future decisions and processes will be based.

Creditors' groups

A different way of saying "this Company is financially distressed" is saying "this Company has an issue with its creditors." As previously noted, the exact nature of the creditor issue will vary by circumstance; however, the most common is where a company faces a default under an existing debt document or the company's options are constrained by its existing debt documents. Breaching a covenant often is viewed as evidence of a short-term issue or possibly more serious corporate health problems down the line. For example, a company might have a short-term problem if a discrete operational issue leads to a bad financial quarter, causing the company to violate a minimum liquidity covenant. Alternatively, if a company trips a financial leverage test covenant, that may be indicative of a larger, fundamental capital structure issue.

If distressed companies are like professional sports teams preparing for an upcoming season, then creditors are like the team's conference rivals. They too can identify prospective distressed situations over the horizon. Where trouble lurks, similarly situated creditors often will form informal "ad hoc" groups to proactively engage and transact with the company ahead of a restructuring catalyst. The lenders in these groups can span the entire ecosystem of financial lending, including commercial banks, large asset management firms, hedge funds that invest in stressed or distressed debt, and more recently, issuers of collateralized loan obligations. Other investors, recognizing a potential opportunity to acquire control of the company through a restructuring process, may also purchase the debt to pursue a "loan to own" strategy.

The circumstances of the company's challenges will directionally shape a creditor group's strategies and tactics. One reason that negotiations with creditor groups can often be challenging is that creditors are rarely uniformly aligned on acceptable outcomes. For example, some creditors may aim to tighten debt terms to provide more credit or collateral protection. More aggressive creditors, on the other hand, may want to transform a company's fundamental decision-making process by supplementing the board or management with creditor-friendly representatives or by requiring strategic milestones to a preferred outcome (e.g., asset sale or refinancing milestones).

Practical tips for officers and directors to keep in mind when engaging with creditor groups include:

— **Confidentiality:** Companies must ensure that creditor groups preserve confidentiality. News of financial distress often results in unwelcome operational challenges, including tightened vendor credit terms, key employee departures and deteriorating customer confidence. Maintaining confidentiality also best protects against opportunistic ploys from more aggressive creditors who may seek to trade into a struggling company's capital structure to execute more aggressive control-based strategies in pursuit of a value windfall.

— **Staging discussions:** Companies often work "down" their capital structures to address weaknesses. Said differently, officers and directors generally should commence conversations with their senior-most lenders before focusing on more junior classes of debt or equity (unless and until such senior obligations are shown to be fully secured and therefore "money good"). A company is well-advised, of course, to maintain good relationships with major constituency groups throughout its entire capital structure; the potential duration of restructuring transactions and risk of shifting interests or conditions may change the focus or relevance of key constituencies in unpredictable ways.

— **Understanding the counterparty:** Officers and directors should understand the nature of the debt being restructured in order to understand what realistically can be accomplished. For example, if the restructuring transaction requires an amendment to a bond indenture, then starting negotiations with a creditor group likely may make good sense only if it has the requisite amount of bondholders needed to deliver the vote. Whether corporate debt is closely held or publicly traded will also impact the likelihood of a successful restructuring transaction. Restructuring a series of bonds widely held by thousands of parties through an exchange offer is much harder than restructuring a term loan held by three banks. Understanding whether one restructuring option creates more of a "free-rider problem" than competing alternatives may shape the company's restructuring calculus. Moreover, different parties may have different appetites for investing new capital in the company, which may be driven not only by the fund's credit assessment of the company, but also by their fund structure or their stage in the lifecycle of the fund. Fund investment parameters may also drive whether the lender is willing to (or even can) accept certain forms of exchange consideration, such as equity.

Equity

Distributable value in corporate reorganizations flows like a waterfall — secured creditors generally must be paid in full from collateral before unsecured creditors, and unsecured creditors generally must be paid in full before equity holders. Depending on the situation, a company's equity owner might be "out of the money" and play very little role in a restructuring transaction, or be the chief engineer of an out-of-court restructuring designed to protect its existing equity position. When thinking about the role of equity, officers and directors should keep a few key concepts in mind:

— **Public versus private companies:** If a company is privately held — such as a private equity firm portfolio company or family-owned business — the board dynamics may be very different from those of a publicly traded company. Privately held company boards often include individuals who are not considered "disinterested." Officers and directors must understand their own potential conflicts, and how the collective composition of the board could shape restructuring negotiations. For example, portfolio companies with many conflicted board members generally have the potential to cause more concern for creditor groups than publicly traded companies with numerous disinterested board members. This dynamic could determine how much flexibility creditors are willing to give the company post-restructuring transaction. In addition, boards composed of "interested" directors are more likely to have their loyalties questioned, including through claims that certain actions would violate their fiduciary duties.

— **Independent directors and special committees:** Private equity sponsors or other equity holders might try to offset the perception that a company board is favoring equity by appointing disinterested "independent" directors. If there are multiple independent directors, they might form a special committee that evaluates certain transactions without involvement or deliberation of "interested directors." A process that lacks actual (or perceived) impropriety can minimize potential future assertions of directors' and officers' liability and the risk that courts may later second-guess the company's decisions. Over the past decade, it has become increasingly common for independent directors and special committees to hire their own special counsel (i.e., separate from the company's restructuring counsel) to further ensure procedural and substantive impartiality. By proactively taking these corporate governances steps, officers and directors help avoid the need for separate, potentially more hostile investigations later in the restructuring process.

— **Interests:** While the exact interests of equity holders will depend on the economics of the situation, two interests are often at the top of their minds. *First*, protecting their prior investment in equity value and potential upside to the extent possible. Perhaps the simplest way to accomplish this is by ensuring that existing management can focus on operating the business. *Second*, if the company has filed for bankruptcy, equity holders usually will seek some reassurance that they (and any affiliated personnel) will not be sued after the bankruptcy case. In most Chapter 11 cases, a plan of reorganization accomplishes this goal through releases, which can either be consensual or, in narrow circumstances, non-consensual.

Official committees

Up until this point, you might think that only large financial institutions have a say in corporate restructurings. While they are undeniably loud voices in the room, the Chapter 11 bankruptcy process ensures that other, smaller economic actors will also be heard. This is most prominently accomplished by the appointment of "official committees," each of which is tasked with representing the collective interest of similarly situated parties. As an initial matter, official committees are only formed in the context of Chapter 11 proceedings. The most common official committee is the official committee of unsecured creditors, which is formed in most complex Chapter 11 bankruptcies. Some bankruptcy cases include appointments of multiple official committees, such as an official committee of tort claimants or even an official equity committee.

Official committees are appointed by the United States Trustee's office, a branch of the Department of Justice. In forming an unsecured creditors' committee, the United States Trustee generally seeks to appoint five to seven sizable unsecured creditors with differing natures of unsecured claims. It is often common to see landlords, trade creditors, indenture trustees or litigation counterparties serve together on an unsecured creditors' committee. The diverse mix of creditors — some of whom may not be familiar with the Chapter 11 process — can complicate the company's negotiations with the committee; however, any committee members lacking sophistication will have the benefit of separately retained legal and financial advisors (whose fees are paid by the debtors' estates).

Official committees owe fiduciary duties to the stakeholders they represent. The discharge of these duties often manifests itself in attempts to increase their stakeholder constituents' realized recoveries through actual or threatened litigation and other forms of process leverage. Moreover, as fiduciaries, official committees are typically given a significant amount of respect by bankruptcy judges, who also expect official committees to serve as de facto checks on the debtors throughout the case. This deference — and the fact that creditor committees are typically one of the more sympathetic actors in Chapter 11 cases — makes official committees powerful allies (and adversaries) in the Chapter 11 process.

United States Trustee's office

The United States Trustee is the government "watchdog" over bankruptcy cases. The office has a variety of roles throughout a Chapter 11 case, including serving as a check on the debtor before the appointment of a creditors' committee, appointing official committees and collecting bankruptcy-specific fees owed to the federal government.

Officers and directors can associate the United States Trustee with an underlying principle of the Chapter 11 process: extreme disclosure and transparency. Once a company files for Chapter 11 relief, for example, it must file an exhaustive amount of financial information, including monthly operating reports, schedules of the company's assets and liabilities and statements of past financial affairs. In addition, the United States Trustee must hold a meeting where the company's creditors can ask a member of the debtors' senior management team questions about its financial disclosures. Unlike the many economically motived restructuring players, the United States Trustee represents an entire different set of interests — protection and clarity of process — that can further serve to complicate the company's restructuring goals.

Bankruptcy judges

The final key actor worthy of discussion arguably holds the most power in a Chapter 11 case — the bankruptcy judge. Bankruptcy judges oversee the entire bankruptcy court process: one day they are entering ministerial orders, and the next they are ruling on legal issues that shift millions of dollars in value (or more) between constituencies. As courts of equity, bankruptcy judges have tremendous flexibility under federal law to fashion equitable results.

Each federal district court has its own set of bankruptcy judges. Certain jurisdictions are known for handling complex Chapter 11 cases, such as Delaware, the Southern District of New York and the Southern District of Texas. Occasionally, judges in these jurisdictions might have rulings or practices that prompt a company to file in a specific jurisdiction, or avoid a different jurisdiction. Understanding how a specific judge is likely to react to proposals made throughout the case — such as granting certain relief on the first day of the case to ensure an orderly transition into Chapter 11, granting third-party releases, approving management incentive plans or how much deference will be given to a creditors' committee — helps ensure that the company will be able to navigate the Chapter 11 process smoothly. Accordingly, it is not uncommon for companies to hire local counsel that are deeply familiar with their local bankruptcy judges.

Conclusion

Restructuring transactions are often opportunities for companies to right-size their capital structures and optimize their go-forward business plans. To maximize this opportunity, corporate decision-makers must understand and appreciate the unique dynamics each restructuring presents. We hope this chapter provides directors and officers with the tools to begin thinking through restructuring issues, and convinces them to engage experienced restructuring professionals to help guide them early in the process.

2.I THE ROLE AND DUTY OF THE BOARD OF DIRECTORS AND THE SPECIAL COMMITTEE OF THE BOARD IN DISTRESSED SCENARIOS

LEGAL PERSPECTIVE

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Imagine you are on the board of directors of a company. The company's performance has taken a turn for the worse and a restructuring may be necessary. Are you ready for what comes next? There are many paths to a successful in-court or out-of-court restructuring, but the foundation is always the same — the right process. Who should be involved in that process? What should that process look like? Two critical questions — among a myriad of others — directors should be asking when signs of distress appear and before declining performance becomes a full-blown crisis. The answers to those questions are highly fact specific.

In complex restructurings with existing or foreseeable conflicts, that process usually entails the appointment of one or more disinterested, independent directors with restructuring experience who typically act as part of a special committee with a specific mandate. These mandates may range from investigating prior company conduct to determine whether any estate claims exist and should be prosecuted or settled to negotiating and authorizing transactions. Mandates often change as a company's needs and goals evolve.

Even in restructuring matters where conflicts are unlikely to arise, a company in distress will experience divergent interests, not only among stakeholders but also within different stakeholder groups. The addition of one or more independent directors with restructuring expertise may address any doubt stakeholders have regarding process and provide the board with experience critical to navigating unchartered territory. A special committee also may support the board when the frequency and intensity of high-stakes, restructuring-specific decisions increase, allowing the board to centralize the process for evaluating, negotiating, recommending and/or authorizing restructuring solutions. And the list goes on.

The right approach depends on the facts and circumstances of each situation, including if a special committee of disinterested, independent directors is appropriate and the

[1] The author would like to thank her Weil restructuring colleagues in connection with the preparation of this chapter: Bryan Podzius and Janiel Myers for their substantial contributions.

scope of the committee's mandate. Proactive planning is essential to risk mitigation and can provide tremendous value to a restructuring. The right process will enhance the governance credibility of the governing body, making the distressed company's decisions less likely to be challenged by parties in interest and, if challenged, more likely to be entitled to deference under the business judgment rule. Good process also can help the company build trust with stakeholders to produce consensual, value-maximizing outcomes. Consensus can expedite restructuring solutions and, in turn, minimize the costs attendant to a restructuring process. The wrong process, on the other hand (including cosmetic fixes), can derail a restructuring.

Laying the foundation

Determining the appropriate process requires a thorough understanding of a director's fiduciary duties and the scope of those duties.

Generally, directors owe duties of care and loyalty to the corporation and its shareholders and must act on an informed basis, in good faith and in the honest belief their actions are in the best interests of the company. The fiduciary duties of boards of directors and the standards of review for evaluating director decision-making are governed by the laws of the particular jurisdictions in which their companies are incorporated. Unless otherwise noted, this chapter focuses on Delaware law, which is, according to Delaware.gov, the legal home to over 1 million business entities. The laws of other jurisdictions may differ.

A director's primary fiduciary duties are the duties of care and loyalty (each of which encompasses, or from which stem, other duties, such as the duty to act in good faith).

Duty of care

The duty of care requires directors to make informed, deliberative decisions based on all material information reasonably available to them using the amount of care an ordinarily careful and prudent person would use in similar circumstances (see *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (quotations omitted)). In exercising their duty of care, directors may rely in good faith on the records of the corporation and on information, opinions, reports, or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care (see Del. Code Ann. tit. 8 § 141(e) (quotations omitted)).

Duty of loyalty

The duty of loyalty requires directors to act in good faith and in the best interests of the corporation and its shareholders and abstain from taking actions that would put the directors' interests ahead of those of the corporation or its shareholders (see *Walt Disney*, 907 A.2d at 750–51 (quoting *Guth v. Loft, Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939))). The duty of loyalty is implicated where directors are interested in the outcome of a transaction — by appearing on both sides of a transaction or deriving a benefit not shared by other shareholders — or lack independence to consider objectively whether the transaction was in the best interests of the company and its shareholders. A director lacks independence when they are beholden to another party or so under the influence of such party that the director's discretion would be called into question (see *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993)). The creation of a special committee of disinterested, independent directors is one procedural safeguard used to resolve duty of loyalty conflicts. More on independence is discussed later in this chapter.

Insolvency

Whether a corporation is solvent or insolvent, directors owe their fiduciary duties to the corporation (see *N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007)). In a solvent corporation, those duties inure to the benefit of shareholders. When a corporation becomes insolvent, directors must continue to maximize the value of the company, and their fiduciary duties remain owed to the corporation but practically benefit all of its residual claimants, which now include creditors (see *Quadrant Structured Products Co., Ltd. v. Vertin*, 115 A.3d 535, 546-47 (Del. Ch. 2015)).

Business judgment rule

In discharging their fiduciary duties, the business judgment rule, generally, protects directors. The business judgment rule is a powerful presumption that, in making a business decision, the directors acted on an informed basis, in good faith and in the best interests of the company (see *Walt Disney*, 907 A.2d at 747). The party challenging the directors' decision bears the burden of rebutting the presumption. As long as directors' decisions can be attributed to a rational business purpose, courts will not second guess those decisions. However, if this presumption is rebutted, then the more stringent entire fairness standard of review applies. Establishing a special committee of disinterested, independent directors at the outset of a potential restructuring increases the likelihood that, in the event of a challenge, the burden of proof rests with the plaintiff.

Independence

In distressed situations, there may not be enough value to satisfy all creditors or provide a recovery to equity. As a result, it is often the case that directors are called upon to choose from restructuring options that may limit creditor recoveries or dilute (or even wipe out) equity interests. This means restructuring decisions by directors will be carefully scrutinized, in particular by "out of the money" stakeholders. This is particularly true when fiduciaries may have relationships to stakeholders whose interests conflict with those of the company.

Whether a director is independent largely depends on the situation and its context and must be evaluated on a case-by-case basis after careful consideration of all relevant facts, including a director's background, business history and personal relationships. For example, the New York Stock Exchange ("NYSE") defines an independent director as one who the board "affirmatively determinates" has no "material relationship" with the company "either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company" (*NYSE Listed Company Manual*, Section 303A.01-02). While the NYSE listing rules go on to provide certain independence disqualification rules, commentary also advises that boards making independence determinations should broadly consider all relevant facts and circumstances. The Nasdaq Stock Market listing rules have similar — but not identical — requirements for independence. Listing requirements and the like are helpful guidelines, but they should not take the place of a review of all relevant facts and circumstances on a case-by-case basis.

Independence in practice: guidance from an unsuccessful challenge

The unsuccessful challenge by certain stakeholders of the special committee's independence in the recent chapter 11 cases of *EP Energy Corporation*, Case No. 19-35654 (MI) (Bankr. S.D. Tex.) are illustrative. In *EP Energy*, the unsecured creditors' committee, an ad hoc group of unaffiliated senior secured noteholders, and certain other parties lodged objections to the debtors' motion seeking approval of a backstop agreement that provided, among other things, for a backstop of $463 million of an up to $475 million equity rights offering in connection with the debtors' plan of reorganization. The backstop agreement was approved by the debtors' special committee and, as is typical of backstop agreements, the commitment parties were to receive certain consideration for their backstop commitments.

The objectors claimed, among other things, that the debtors' sponsors — two of which were commitment parties under the backstop agreement — had massive influence over the debtors generally and the debtors' restructuring process specifically, the debtors' special committee was not truly independent, the debtors only negotiated with their sponsors while ignoring the ad hoc group, and the ad hoc group's proposal was better than the debtors' plan of reorganization.

The objectors also argued that, because the backstop agreement involved and benefited the debtors' sponsors, the debtors' decision to enter into the backstop agreement should be reviewed under the heightened entire fairness standard and not the business judgment rule.

The debtors' key responses included:

— The proper standard of review of the backstop agreement was business judgment and not entire fairness because the sponsors were not controlling shareholders and the sponsors could not have controlled the decisions at issue. The special committee of independent, disinterested directors had full authority with respect to the backstop agreement. In addition, the backstop agreement was extensively negotiated at arm's length and the evidence did not support the application of the heightened entire fairness standard.

— The special committee was comprised of three non-executive, independent, and disinterested directors. Each committee member met the U.S. Securities and Exchange Commission and NYSE independence standards as well as the debtors' corporate governance guidelines. In reaching this determination, the debtors explained that they reviewed each director's commercial and charitable relationships as well as any potential related party transactions — concluding that none of the committee members were beholden to or had any current business or pecuniary relationship with any of the debtors' sponsors. Although two committee members previously had served on the board of a sponsor's portfolio company for four months or less and were designated by a sponsor to serve on the debtors' board, this was insufficient on its own to establish that such members were beholden to the sponsors.

— The special committee was delegated full power to make all decisions regarding restructuring transactions, including the backstop agreement, and did make all such decisions with the advice of experienced legal and financial professionals. (Full disclosure: the debtors advisors included Weil as counsel, Evercore as investment banker, and FTI as financial advisor.) The debtors' special committee was appointed in June 2019 — over three months before the debtors' petition date and before the debtors engaged in any discussions with stakeholders. Although the sponsors had employees on the debtors' board, the special committee was granted full power and authority with respect to a transaction and did not need to return to the board for guidance or authorization, including with respect to the backstop agreement. The directors employed by the sponsors were not involved in any negotiations or deliberations on behalf of the debtors and were recused from all board meetings and calls early in the strategic process.

— Contrary to the objectors' unsupported allegations, the sponsors did not improperly influence the special committee or the debtors' restructuring process. In addition to recusing themselves from board meetings and calls beginning in June 2019, the sponsors ceased receiving any confidential information in their capacity as shareholders and their affiliated board members ceased receiving any confidential information in their capacity as directors. The sponsors did not attend a single special committee meeting and, as discussed previously, the special committee was the sole authority with respect to the debtors' restructuring transactions. The sponsors engaged with the company as stockholders only until June 2019 and then as creditors, but in all cases at arm's length.

— The debtors ran a fair and exhaustive process in good faith and with due care. The committee met regularly, consulted with management and experienced advisors, explored all options, had numerous calls and meetings and exchanged restructuring proposals with, among others, advisors to the various stakeholders such as the ad hoc group and ultimately chose the transactions presented as what the committee believed to be the most value-maximizing for all stakeholders. The debtors noted that the special committee met for months, weekly or bi-weekly, between its formation in June 2019 and when the debtors' commenced their Chapter 11 cases in October 2019.

— Although the debtors believed that the business judgment rule should apply, the debtors also asserted that, even if applicable, the record would show that the debtors also satisfied the entire fairness standard.

After a two-day contested hearing, the court approved the backstop agreement. The court found that the debtors' witnesses were credible, the debtors' special committee was independent and the business judgment rule should apply. With respect to Ms. Flaton, the chairwoman of the special committee who testified, the court found that she was an extraordinarily credible witness, was independent and made independent decisions. The court went on to find that the special committee not only worked, but did its job, highlighting in its bench ruling that the special committee met more than 30 times, spent hundreds of hours considering strategic alternatives, retained high-quality advisors and followed such advisors' advice — all of which supported that the special committee acted independently.

The court noted that there were certain links between the committee members and the sponsors — in a "Six Degrees of Kevin Bacon" sort of way. However, the court explained bringing in a director because you know the director is qualified does not mean that the director is beholden to the party who brought them in. Here, the court found no evidence suggesting otherwise, relying on the credible testimony of the debtors' witnesses.

In addition to providing some context with respect to independence, EP Energy also underscores the importance not only of process, but on the perception of that process by the court and stakeholders. Even though the objectors lodged unsupported allegations with respect to independence and presented no witnesses at the hearing, it was critical for the record to show that the debtors were proactive in reviewing their corporate governance structure and implementing appropriate changes in a timely fashion — here, the formation of a special committee of independent, disinterested directors with full decision-making authority over the debtors' restructuring transactions. Not only did this allow the debtors to dismiss such unfounded claims and prevent the objectors from tainting an otherwise unchallenged process, but it resulted in the application of the business judgment rule rather than the heightened entire fairness standard.

Approval of the backstop agreement paved the way for confirmation of EP Energy's plan of reorganization in March 2020, approximately five months later. Unfortunately, shortly after confirmation, market conditions — including Saudi Arabia and Russia implementing price reductions that caused U.S. oil prices to fall by more than 30 percent and the continued spread of COVID-19 and its impact on the financial markets — challenged the debtors' ability to consummate their plan. At the same time, the backstop parties asserted certain claims in connection with confirmation. Following the above, the debtors stipulated to consensually terminate the backstop agreement and related plan support agreement and the court vacated its confirmation order. Thereafter, the debtors proposed an amended plan which was confirmed in August 2020 and went effective in October 2020.

Restructuring efforts derailed by lack of independence

Coram Healthcare is a prime example of how a superficial approach to independence may impede a debtor's reorganization efforts (*Coram Healthcare Corp.*, Case No. 00-3299 (MFW) (Bankr. D. Del.)). In *Coram Healthcare*, the court denied confirmation of the debtors' initial plan of reorganization because the debtors' chief executive officer ("CEO") was also a consultant of one of the debtors' noteholders. The court held that this conflict of interest tainted the debtors' restructuring and negotiations toward a plan and violated the requirement under section 1129(a)(3) of the Bankruptcy Code that the debtors propose their plan in good faith.

Thereafter, the debtors formed a special committee of independent directors to propose a new plan. Other than hiring a financial advisor and reviewing the advisor's report, the court found that the special committee took no action in response to denial of confirmation. The CEO continued to receive compensation from one of the debtors' noteholders pursuant to a consulting arrangement that required him to obey the noteholder's instructions or risk his compensation — in the amount of $1 million per year — while continuing to serve as CEO. The special committee did not conduct any investigation of the CEO's conflict of interest, did not require that the CEO cease accepting compensation from the noteholder and did not ask the CEO whether the conflict was on-going. While the special committee and its financial advisor's report focused on disclosure of the conflict, they did not require that the CEO disassociate himself from the noteholder to create separate boundaries between the debtors and the relevant noteholder in formulating their plan. The court denied confirmation a second time. A few months later, a Chapter 11 trustee was appointed and around two years later, the trustee confirmed a plan.

Conclusion

The right process requires the right foundation — a thorough understanding of a director's fiduciary duties and the scope of those duties. Only with such an understanding can a director of a distressed company assess the appropriateness of the existing process for what may come next. Maybe the board could benefit from the appointment of additional disinterested, independent directors with restructuring experience or the formation of a committee of the same. If so, selecting the right person with the right experience is just the start. Directors should ensure that the scope of their authority in authorizing resolutions allows them to fulfill their mandate and does not undermine or otherwise compromise the same. Directors should also assess whether they are implementing best practices such as keeping a regular cadence of meetings — the frequency of which will depend on the circumstances — and keeping minutes of the same. Irrespective of the ultimate path chosen, an honest assessment will demonstrate the board's commitment to objectivity, pave the way for any changes should they be warranted and increase the likelihood that the company's restructuring decisions will be entitled to the protection of the business judgment rule (and, in the event of a challenge, that the burden will rest with the plaintiff). Those are some of the obvious benefits. The not-so-obvious benefit is that process integrity can build trust with stakeholders and help lay the groundwork for consensual restructuring solutions.

2.II THE ROLE AND DUTY OF THE BOARD OF DIRECTORS AND THE SPECIAL COMMITTEE OF THE BOARD IN DISTRESSED SCENARIOS

FINANCIAL ADVISOR PERSPECTIVE

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Governance duties

The fiduciary obligation of the board of directors and any Special Committee it may appoint is to exercise the duty of care and the duty of loyalty that serves the best interests of the company and its stakeholders. The duty of care generally means a board must exercise good business judgment when making decisions, using appropriate available information. The duty of loyalty generally means a board must be loyal to the company, putting the company's interests ahead of their own, and not engaging in self-dealing transactions. Breach of these duties is regularly cited in lawsuits against directors.

Common problems that directors often face in exercising the duty of care include the following:

a. **Being overly optimistic about business performance:** Boards must make a sound assessment of performance expectations for the company. Brushing off recent poor or disappointing results as anomalous or non-recurring or assuming aggressive sales targets will be hit next year may not be a reasonable expectation. Directors must apply a keen eye to forecasts with unrealistic expectations, particularly when dealing with an entrepreneurial founder/owner of a business. If forecasts appear too good to be true, the board can request a "downside scenario" showing what would happen in a more reasonable forecast with more moderate assumptions for key business variables.

b. **Relying on inaccurate or stale data:** Especially when assessing solvency, the board cannot just rely on historical financial statements to inform their performance and liquidity expectations. Real-time information should be evaluated and discussed (e.g., sales trends from prior week, current cash balances, variance analysis, and near-term liquidity forecasts) so the board is fully informed and up to date on operations and liquidity. During periods of business adversity, prior forecasts can unravel quickly, and even relatively recent historical data may become misleading for forecasting purposes.

c. **Not convening often enough:** Boards should be receiving regular updates and be kept abreast of any material changes in real time. A board may consider a standing monthly (or possibly even weekly) meeting to stay abreast of recent events in times of distress to facilitate timely decisions.

d. **Waiting too long to take action:** When a company approaches insolvency, it is common to wait until there is "definitive evidence" before taking action. This is understandable; after all, how could a director vote to file for bankruptcy before it is absolutely necessary? However, waiting too long could lead to a scenario where a company runs too low on liquidity, cannot obtain committed DIP financing in advance of a filing, or is unable to effectuate a restructuring or sale, but rather may be forced to liquidate its assets and shut down its operations.

e. **Not listening to experts:** Reliance on the company's experts is considered a best practice. This could include an internal engineer regarding technical issues or problems with product launches, as well as a bankruptcy attorney who can guide the board on the pros and cons of filing a bankruptcy or staying the course. Showing evidence that board members sought to inform themselves regarding key issues is an effective defense against future breach of fiduciary duty claims even if the guidance provided by experts was flawed. Accordingly, a director should be wary of disregarding advice from experts, as this could later be used against the director in a breach of the duty of care lawsuit.

Common problems that directors often face in exercising the duty of loyalty include the following:

a. **Inadvertently (or intentionally) putting personal interests first:** Many directors are also equity investors, hold debt positions, or are part of management. Directors need to be mindful of their own positions in these other roles or capacities and must be sure to make decisions that are meant to maximize value for the benefit of all constituents, not to their personal interests. The board should also be cautious about the company taking on unnecessary or large risks with limited or dwindling capital, particularly if the goal is to benefit equity at the expense of current creditors. This is also known as a "swing for the fences" business strategy arising from the realization the equity stands to benefit from the payoff of a high return/low probability venture while it has little else to lose. An example would be an energy company allocating an outsized amount of its remaining liquidity on exploration costs to find new reserves even if this is an unlikely outcome. When a company reaches a point where it is possible that the company is insolvent (referred to as "The Zone of Insolvency"), the number of parties to which a director owes a fiduciary duty expands to include the company's creditors.

b. **Not recusing themselves:** In a situation where a director has a conflict of interest, it is generally best to recuse himself or herself from any votes on that matter. Taking it a step further, the director might opt to forgo attending the board meeting, so as not to inadvertently speak up with the wrong or misinterpreted intentions. Notably, in a lawsuit, board minutes are discoverable.

c. **Causing undue influence of other directors:** Directors regularly have offline conversations to advocate for their positions, and this is generally a sign of a healthy, active board. However, in a distressed situation, a director must be cautious of these conversations, especially if they are sharing information that is not available to all directors. When in doubt, save this advocacy for meetings where all directors are present.

d. **Caving to demands of the "loudest" creditors:** In distressed situations, there is a good chance that large creditors stand to lose millions of dollars. Some will be very proactive, both before and after a filing, to demand repayment, impose unfair terms, or extract other concessions from the company that protect or minimize their financial exposure. The board must be sure to not give in to any unreasonable demands, and make sure that their actions maximize value and are in the best interests of the company and all its stakeholders.

Insolvency considerations

From a business perspective, a board's primary goal is to maximize the value of the enterprise and, by extension, shareholder wealth. This is true whether a company is small or large, healthy, or distressed. As a board, decisions should be made in the best interests of the business. For a healthy business, that means acting in the best interests of the company and its equity holders. As such, the board's fiduciary duties rightly serve these interests.

There is a common phrase in restructuring circles, the zone of insolvency, which refers to the gray area when a company is on a path toward becoming insolvent or is potentially insolvent already. As a company approaches insolvency, the board's fiduciary duties are still owed to the company for the benefit of its residual beneficiaries — equity holders — with a goal of maximizing the equity returns.

As previously discussed, once a business becomes insolvent, the board's fiduciary duties expand to include all equity holders and all business' claimants including trade and business creditors as well as providers of capital. Practically speaking, if a company is insolvent, it is assumed that equity holders' claims have minimal, or no value and it is common for creditors' claims to become equitized in the event of a reorganization.

It is very difficult, if not impossible, to pinpoint the moment a company becomes insolvent, and it is not necessarily the board's job to make that precise determination as it occurs. However, the board should have an understanding of the company's likelihood of being insolvent at any point in time.

So, how will a board know if the business is insolvent and when its fiduciary duties expand from equity holders to all creditors of the business? While it is difficult to recognize in the moment, there are three tests that courts generally rely on for this determination. These tests are usually performed retroactively after a litigation has been filed. The three tests are:

a. **The balance sheet test:** Do the company's assets exceed its liabilities?

b. **The cash flow test:** Can the company pay its debts as they become due?

c. **The unreasonably small capital test:** Does the company have enough capital (or access to capital) to maintain its future operations?

While these three tests are interrelated, in litigation, a claimant only needs to prove that the company fails one of the three tests to establish insolvency. Directors should be aware of these tests when a company is in the zone of insolvency. It should request regular updates from management and its independent advisors regarding the financial condition of the company as measured by recent financial results and current forecasts.

Below are a few items to be cognizant of while in the zone of insolvency:

a. **Understand the company's balance sheet and value:** This does not refer to just the company's GAAP-compliant financial statements but should also consider the market value of its assets as well as contingent liabilities that may not be included on the balance sheet. It is critical to understand any off-balance sheet liabilities (such as guarantees of other entities or lawsuits that will likely lead to a judgment against the company) and the true value of debts owed, such as pension fund obligations or environmental liabilities, where the accounting treatment may differ from the ultimate liability.

b. **Understand the company's liquidity position:** Does the company have enough cash to cover its payment obligations each week? Is there enough in reserve to cover payroll, or is the company relying on one or two big cash receipts to cover each payroll? Does the company have a rolling 13-week cash flow, and how much liquidity is available for this period?

c. **Understand the company's access to capital:** Does the company have adequate cash or working capital to operate indefinitely? Does it have access to a line of credit? What is the likelihood the company can raise additional funds from capital markets? Will it be able to refinance an upcoming debt maturity?

These questions do not have definitive answers and will be subject to differing opinions from different constituents. Equity holders will be motivated to assume a more upbeat outlook than a secured lender. These various constituents will, in many circumstances, also have different opinions on the appropriate path forward. When determining the solvency of a company through a value (or, more likely, a range of values), the board must come to a reasonable conclusion on solvency when assessing its decisions for the future. The board will proactively seek advice from outside legal counsel or financial advisors to determine if the company is in the Zone of Insolvency.

When choosing a path forward, the board can rely on a reasonable conclusion related to the company's solvency. Boards are granted wide latitude when making decisions, and even in retrospect can defeat spurious creditor actions or lawsuits through the business judgment rule.

The business judgment rule is a defense that the board acted appropriately when making its decisions. Courts generally look to see that boards performed their duties:

a. in good faith;

b. with the care that a prudent person would exercise in a similar situation; and

c. in a manner the directors reasonably believed to be in the best interests of the company.

If a board reasonably acted per these standards, they should be justified in their decisions even if it led to an unfavorable outcome.

However, this does not mean directors are in the clear for all aspects of the business. For example, directors can be personally liable for various trust fund debts if mishandled, such as payroll withholdings and sales taxes. Trust fund debts include cash that is collected or withheld by the company and remitted dollar-for-dollar to a taxing authority. When in the zone of insolvency, the board should ensure that the company always has enough cash on hand to remit its trust funds (or better yet, that these funds are remitted immediately to the taxing authorities).

As a company approaches or enters the zone of insolvency, the board should be extra sensitive to its duties and ensure it is seeking to maximize value and is acting in the best interests of the company and all constituents, not just equity.

a. The board should convene regularly and require additional reporting and information be presented.

b. If any directors have questions regarding their duties and how these duties change in a distressed situation, they should discuss with counsel and clear up any misconceptions.

c. If there are concerns regarding conflicts of interest (whether warranted or not), the board should consider appointing new independent directors, and individual directors should consider recusing themselves from key votes regarding their other interests.

The role of a special committee

A Special Committee is comprised of a working group of independent directors with the directive to consider all the facts and make decisions that are in the best interest of the company's stakeholders. These decisions often involve reaching resolutions or approving agreements or transactions where there may be perceived conflicts of interest for other members of the board. In order to fulfill its role effectively as an independent and impartial proxy for a disinterested board, the Special Committee should have a clearly defined mandate that will provide the committee with the following:

a. Ability to retain independent legal and financial advisors to assist the Special Committee in its decision making; many times the Special Committee will work with the existing professionals that are retained by the company

b. Authority to directly guide the management team in carrying out the objectives of the Special Committee

c. Be provided access to all relevant data and analyses that the Special Committee will need to consider in evaluating the merits of each decision

d. Given the authorization to negotiate with interested parties on behalf of the company's stakeholders

e. The power to direct management and enforce such decision over potential objections from interested directors and officers

While it is often the case that a Special Committee has full authority, there are situations where a Special Committee is only granted limited authority. This can remain limited or be expanded to full authority depending on the circumstances.

It is imperative for the Special Committee to consider the options and receive the proper financial and legal advice from independent advisors in order to exercise due care in protecting the company's interests. In a restructuring context, the key areas of focus for the Special Committee include the following:

1. Contingency planning

During a restructuring process, the Special Committee will need to work closely with the management team to carry out its objectives. As such, the Special Committee should consider the appropriateness or necessity of a key employee retention plan ("KERP") to motivate employees to stay with the company and work towards a successful outcome. Pre-petition KERP is a retention program that is put in place prior to a Chapter 11 bankruptcy filing and often provides for upfront payments with claw back provisions to the extent the employee leaves. This type of program is useful in retaining key employees during a period of distress where there are restructuring negotiations with key constituencies outside of a bankruptcy. The Special Committee should work with an independent compensation expert to ensure that the value of the payment and claw back period are fair and effective.

To the extent a retention program has not been put into place prior to a Chapter 11 bankruptcy filing, the special committee should design and proposed a Key Employee Incentive Plan ("KEIP") which will require bankruptcy court approval. Whereas post-petition KERP (if allowed by the Court) typically provide for retention payments to employees (with significant restrictions to executive management or insiders) on the condition that they stay with the company throughout the bankruptcy process, KEIP plans reward management level employees for achieving specified milestones or during the bankruptcy. The Special Committee should work with an independent compensation expert on matters related to KERP and/or KEIP to ensure that such plans are effective, fair and supportable.

The Special Committee, working with management, should carefully review the directors' and officers' insurance policies and plan for the renewal or purchase of additional add-on coverage. The Special Committee and management should also consider a directors and officers ("D&O") tail policy that would cover potential claims against the directors and officers for a period of time following a sale or a restructuring transaction. The ability to attain the requisite insurance coverage during a distressed restructuring process may be very limited or prohibitively expensive, so it is important for the Special Committee to ensure that adequate coverage is obtained while the company is healthy. The Special Committee, working with management, should develop a clear communication strategy to ensure that there is consistent messaging to stakeholders and employees. Communications with key stakeholders should be presented with clear intentions and no ambiguity. The Special Committee should keep a careful record of stakeholder communications and ensure that all commitments or agreements are properly communicated to reduce misunderstandings or delays. In addition, prior to an official corporate announcement, the Special Committee and management team, in coordination with a corporate communications expert, should prepare for and initiate the outreach to employees, key customers and key vendors so that the Company can mitigate the risk of potential business disruption following the issuance of a corporate press release.

2. Liquidity runway

A company's liquidity situation will often determine the possible strategic alternatives that a company can pursue. The Special Committee should request a weekly cash flow forecast analysis to better understand the company's near-term liquidity profile. In addition, the company should explore potential sources of additional liquidity from outside parties, contributions from current owners, asset sales, and aggressive cost cutting initiatives.

3. Out-of-court solutions

An understanding of the liquidity runway will inform the Special Committee on the timeline to execute a capital markets solution, sale process and/or out-of-court restructuring transaction. The company may also request more flexibility through the negotiation of credit amendments, waivers, or forbearance agreements with its debt holders. While a collaborative out-of-court solution is less expensive than a Chapter 11 bankruptcy proceeding, negotiations with interested parties can take significant time as debt agreements typically require unanimous consent of debt holders to make fundamental changes to the underlying debt document. This can be made more difficult if there is a complex capital structure with individual debt holders having different incentives or motivations. In addition, there is risk of creditors exercising remedies or taking actions that would be precluded under an automatic stay that Chapter 11 bankruptcy affords. The Special Committee should receive advice on timelines and achievability of an out-of-court solution from its financial and legal advisors.

4. In-court restructuring

To the extent there is limited liquidity runway or if it is determined that an in-court bankruptcy process is preferable (e.g., Inability to negotiate an out-of-court transaction due to complex capital structure or hold-outs; benefit from automatic stay and ability to reject onerous contracts in Chapter 11 process), the company should prepare for an in-court bankruptcy process.

In considering a Chapter 11 bankruptcy filing, the Special Committee should focus on making the process as quick, efficient, and inexpensive as possible. Independent legal and financial advisors should assist the Special Committee in crafting a strategy to shorten the time needed to be in bankruptcy. Chapter 11 bankruptcies can generally occur in three forms:

a. **Prepack bankruptcy:** To the extent a Restructuring Support Agreement ("RSA") can be negotiated and executed with all creditor classes (leaving unsecured creditors unimpaired) that satisfies the voting requirements for a plan of reorganization, the company can solicit votes to accept the plan of reorganization prior to the actual commencement of the Chapter 11 bankruptcy filing. This way, the pre-petition acceptances, and rejections of the plan of reorganization can be used to seek prompt confirmation of the plan of reorganization, subject to guidelines, codes, and rules at court jurisdictions. Prepack bankruptcies provide the shortest duration (2-3 months on average) and lowest cost to the estate. However, the pre-petition negotiation may take a number of months to complete and may be more difficult with complex capital structures.

b. **Pre-negotiated bankruptcy:** Prior to a bankruptcy filing, an RSA is negotiated and executed with a key group of creditors, but without solicitation of votes. Companies will generally choose pre-negotiated bankruptcies if there is also a desire for operational restructuring that will result in impaired unsecured creditors. This will result in a need to form an unsecured creditors committee, file Schedules of Assets and Liabilities and Statement of Financial Affairs and establish bar date for proof of claims. While plan solicitation can still be arranged after bankruptcy commencement, there will still be a need to build time for disclosure statement hearing and confirmation hearing. Pre-negotiated bankruptcies can take 4 or more months to complete because of the risk of objections or alternative proposals from the impaired unsecured creditors. Similar to prepack bankruptcies, the pre-petition negotiation with key creditor classes may take several months to complete.

c. **Free fall bankruptcy:** Occurs when a company files for Chapter 11 bankruptcy without an actionable plan of reorganization. After bankruptcy commencement, the company will negotiate with all creditor classes and build consensus to an acceptable plan of reorganization. Free fall bankruptcies have the longest duration and highest cost.

A Section 363 sale is an alternative that could be pursued but it would in conjunction with either a pre-negotiated bankruptcy or executed after a free fall bankruptcy is commenced. In some cases, a Section 363 sale can be pursued before there is an agreement on how the proceeds of the sale would be distributed under a Plan of Reorganization.

5. Debtor-in-Possession financing (or "DIP financing")

The Special Committee will need to focus on attaining sufficient DIP financing to fund the bankruptcy case through emergence. The Special Committee should work with its financial advisors to size the financing need and secure a DIP loan from either an existing creditor (a/k/a: a "Defensive DIP"), or from a third party. Terms of the DIP loan should be carefully evaluated, and market tested before being accepted by the Special Committee. To the extent credit amendments or waivers are needed during the bankruptcy case, the Special Committee should receive advice from its advisors and carefully evaluate and negotiate terms.

6. Strategic alternatives and business plan development

The Special Committee, with support from its independent advisors, should consider strategic alternatives including selling the whole company, or selling unprofitable divisions to preserve the valuable/profitable core business, or liquidating if there is insufficient value to the business.

To the extent there is going concern value to the company that can support a plan of reorganization, the management team, with assistance from the financial advisor, should develop a business plan that encapsulates the overall business strategy for the company going forward. The business plan should be presented to the Special Committee and board of directors with discussion points on important business plan assumptions which may include the following:

a. Revenue drivers and customer analysis

b. Market trends and competitive environment

c. Vendor relationships and supply/service contracts

d. Sales and marketing initiatives

e. R&D or new product/service initiatives

f. Legal/compliance/regulatory

g. Other operating costs

h. Cost reduction initiatives

i. Profitability by business/product/service

j. Working capital

k. Fixed assets and capital expenditure projects/ maintenance

l. Liquidity

m. Capital structure considerations

n. Potential recovery actions

The Special Committee should carefully review the business plan and discuss the assumptions with the management team and financial advisor before approving it. The business plan needs to be feasible and supportable and will be important for negotiating the plan of reorganization with parties of interest and valuing the business enterprise.

7. Investigations

Over the course of the bankruptcy case, the company may be served with breach of fiduciary duty claims alleging that controlling directors or managers made certain decisions that directly benefited themselves and/or their affiliates instead of acting responsibly in the best interests all creditors and shareholders. The breach of fiduciary duty claims may also be applied to decisions unduly favoring a related party wherein such party is alleged to have a shared business interest, personal/familial relationship or common charitable efforts with the controlling directors or managers. The Special Committee may be tasked with conducting a fairness review to determine whether (i) the process of structuring, negotiating, market testing and approving the transaction was conducted in an unbiased and fair manner and (ii) the negotiated transaction price was in a reasonable range based on economic and financial considerations. It is important for the Special Committee, with the assistance of independent professionals, to investigate the facts and circumstances surrounding the transaction and make a determination of whether such transaction was conducted and priced in a fair manner.

In addition, the Special Committee may be tasked with investigating alleged fraudulent conveyances or preferential transfers that are asserted by parties of interest. These are often related-party transactions where certain members of the board of directors or management team may have derived a benefit from the transfers and would be viewed as having a conflict of interest.

A fraudulent transfer under Section 11 U.S. Code § 548(a)(1)(A)-(B) of the Bankruptcy Code is a transfer that was made within two years before the bankruptcy filing where either:

a. **Intentional (or "Actual") fraud is alleged:** The debtor made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

b. **Constructive fraud is alleged:** The debtor received less than a reasonably equivalent value in exchange for a transfer or obligation; and (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; and (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; and (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or (iv) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

A preferential transfer under section 11 U.S. Code § 547(b) of the Bankruptcy Code is any transfer of an interest of the debtor in property:

a. to or for the benefit of a creditor;

b. for or on account of an antecedent debt owed by the debtor before such transfer was made;

c. made while the debtor was insolvent;

d. made on or within 90 days before the date of the filing of the petition; or between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

e. that enables such creditor to receive more than such creditor would receive if (i) the case were a case under Chapter 7 of this title; (ii) the transfer had not been made; and (iii) such creditor received payment of such debt to the extent provided by the provisions of this title.

In matters related to investigations, it is important for the Special Committee to retain an independent counsel with no pre-existing relationship to the company. Additional independent professionals with the requisite expertise may also be needed for the investigation. In addition, due care should be taken to ensure that communications with counsel are protected under attorney client privilege and that corporate disclosures of investigations are handled seriously and carefully.

The Special Committee has a fiduciary duty to the company, its creditors, and its shareholders to objectively review the facts and circumstances of the transactions, as well as the conduct of the participants. To the extent the investigation is hampered by interested parties, the Special Committee must consider using lawsuits to compel compliance with the Special Committee's requests. The Special Committee may even need to take action to protect the company if there is evidence of continuing inappropriate conduct from interested parties. The Special Committee should properly investigate the allegations and to the extent required, prepare an investigative report, with the assistance of independent counsel, that lays out the investigative process, relevant evidence that was considered, and findings of fact from its independent investigation.

8. Third-party releases

The Special Committee may need to evaluate third-party release provisions (release of causes of actions or claims against related non-debtor parties such as current and former directors and managers) contained in a plan of reorganization. While most bankruptcy courts generally allow consensual third-party releases as long as the release binds only those creditors that (i) voted in favor of a plan of reorganization, or (ii) abstained from voting and did not opt-out of agreeing to the third-party release (with such opt-out provision available to be selected on the voting ballot), there has been ongoing legal challenges associated with non-consensual third-party releases where different court jurisdictions have disparate views on its permissibility. Those court jurisdictions that do permit non-consensual third-party releases generally do so only under specific situations after considering the facts and circumstances of the case, as well as the scope and scale of the releases.

The unsecured creditors committee (and/or equity committee to the extent formed) may also object to third-party releases in a plan of reorganization as they will often seek to preserve the right for causes of action against such parties in a litigation trust or other vehicle that creditors will try and control.

The Special Committee, with the assistance of independent counsel, should consider the scope and scale of third-party releases and evaluate the appropriateness and supportability of these releases when negotiating and confirming the plan of reorganization. The Special Committee may also need to consider (i) settling the potential causes of actions that underly the objections to third-party releases, (ii) negotiating with the unsecured creditors committee and/or equity committee on a carveout and transfer of specific rights to causes of action to the liquidation trust and (iii) adjusting the scope and scale of third-party releases in the plan of reorganization to be acceptable to the court and stakeholders.

9. Plan of reorganization

The Special Committee may consider playing active roles in negotiating the plan of reorganization with key constituencies. While financial and legal advisors can build the groundwork for these negotiations, the Special Committee should provide final approval of agreements to the extent such agreements are in the best interest of the company. Additional considerations associated with developing the plan of reorganization include the following:

- **a.** Valuation and recoveries under the plan of reorganization (in support of Fair and Equitable Test for plan confirmation)
- **b.** Hypothetical liquidation analysis (in support of Best Interest Test for plan confirmation)
- **c.** Financial forecast and liquidity considerations (in support of Plan Feasibility Test for plan confirmation)
- **d.** Capital commitments of plan sponsor
- **e.** Communications strategies and plans
- **f.** Negotiating with key creditor and equity constituencies
- **g.** Navigating key customer and supplier issues
- **h.** Addressing concerns of unions, PBGC (pensions/ "OPEB") and other critical labor related issues
- **i.** Management team and appropriate retention plans
- **j.** Managing legal, compliance, regulatory and other governmental requirements
- **k.** Causes of action
- **l.** Tax strategies
- **m.** Releases and exculpation
- **n.** Evaluate and negotiate terms of exit financing.

Conclusion

The responsibility of the Special Committee is to exercise due care in protecting the company's interests as an independent and impartial proxy for a disinterested board. Under a restructuring context, the Special Committee will need to carefully consider and address a myriad of challenges and problems while developing and executing a strategy to lead the company out of distress. A restructuring plan, whether it is conducted in-court or out-of-court, will require the Special Committee to make informed decisions on each issue that arises, with the assistance and advice of independent advisors with the requisite expertise.

The mandate of a Special Committee should provide assurances that all decisions that are made are fair and not unduly influenced by officers and directors who have a potential or perceived conflict of interest.

3 EXECUTIVE COMPENSATION AND INCENTIVE PLANS DURING RESTRUCTURING

FINANCIAL ADVISOR PERSPECTIVE

FTI Consulting

Martin Kuehne, *Senior Managing Director, Co-Leader of Human Capital*

Companies undergoing financial restructuring face several critical human capital-related issues — which include addressing increased turnover, improving depressed staff motivation, and the need to revise and realign company performance goals and objectives. These issues are often exacerbated by the harsh reality that many existing elements of current total compensation programs, such as annual incentive plans and long-term equity plans, are usually no longer relevant in a distressed financial situation. It is also possible that recent hires or recently promoted executives confront a different compensation opportunity than what they experienced in the recent past, or as outlined to them in the recruitment process, and are at an increased risk of departure at a time when their skills and abilities are most critical for stakeholders.

To address these issues, companies contemplating a restructuring often implement retention and incentive compensation programs designed to retain key employees who are critical to the successful execution of the turnaround plan. These programs are typically put in place in addition to, or in replacement of, existing annual and long-term compensation plans that may have reduced motivational impact due to the diminished likelihood of achieving original plan targets and the outcome uncertainty of the turnaround process. The key is to mitigate or remove as much uncertainty around critical compensation issues as possible, where prudent and necessary, to focus the management team and key employees on performance during a turnaround effort or a restructuring.

During the restructuring process, the design and structure of these retention plans will vary based on whether they are implemented outside of or within a bankruptcy court process, and often include one or more of the following programs: Pre-petition retention or bonus payments, a Key Employee Retention Plan (“KERP”), or a Key Employee Incentive Plan (“KEIP”).

Pre-petition Retention payments are up-front payments made to a select group of executives in anticipation of a Chapter 11 filing and are usually subject to a “clawback” if the executive voluntarily leaves prior to the retention period. These payments are made to offset payments under existing annual incentive programs that will not likely be made due to the company’s financial situation and to provide a method to retain the executive team throughout the restructuring process.

Care and involvement by legal counsel is necessary when implementing pre-petition plans to mitigate the likelihood that payments made prior to filing can be successfully challenged as fraudulent transfers under the Bankruptcy code. Creditors and shareholders may challenge these payments by demonstrating the debtor did not receive "reasonably equivalent value" for the payments. The size of the payments and the structure of the clawbacks are key to ensure that proper value is delivered relative to the retention period.

KERPS are retention plans put in place while a company is under Chapter 11 protection and are usually cash-based for select employees deemed critical to retain for a specified period but do not include the most senior executives (that is, they apply only to non-insiders)**.** KERP plans are typically structured as defined payouts tied to continued employment during the retention period and usually do not include specific performance goals. KERP plans are specifically designed to retain employees during the restructuring timeframe when their efforts are most critical to keep operations ongoing. Key design criteria for a KERP include the following considerations:

— **Eligibility:** Which employees or skills are most at-risk and critical to retain? Should the retention plan include a broader group of employees or be targeted to a smaller group of employees critical to the business? Should any employees who participate in the historical annual management incentive plan be excluded?

— **Timing of payouts:** Should payouts be made in one or more installments, in conjunction with certain events, such as emergence from bankruptcy or the closing of a sale of the company? What happens in the event of termination prior to payment?

— **Target awards:** How large do the payouts need to be to retain key talent? Should they be the same for all employees at the same level or should they vary based on performance, criticality, or risk / impact of loss?

However, for the most senior executives, Section 503 of the Bankruptcy Code ("BAPCPA") impacts the type of retention and incentive plans companies can use in Chapter 11. Section 503 includes limits on compensation that apply to "insiders," which includes directors, officers or other persons in control of the debtor; these are typically Section 16 officers[1] but may include others based on circumstances. For this level of employees, the KEIP must be structured so that payouts are tied to demonstrated performance against financial metrics, and are not just dependent on continued employment like the structure of a KERP.

One of the most critical and challenging steps in designing a KEIP is choosing appropriate performance metrics and setting difficult but achievable goals. Court-approved KEIP plans typically include financial metrics such as EBITDA, cash flow, economic value added ("EVA"), etc., with new "stretch" goals designed to ensure they are incentive-based rather than retention plans. The court will often look to the existing annual incentive plan structure and metrics to determine if the proposed KEIP goals are significantly different from goals under historical incentive plans and actual historical performance levels with some adjustment to reflect the current financial situation of the debtor. Selecting the right performance measures and defining what is "good" performance is critical to establishing the appropriate linkage between pay and performance. Key questions for selecting the right measures include:

— Which key metrics support the go-forward business plan and which measures can be accurately forecast so that achievable goals can be set?

— What metrics were used in the past and are common in the industry?

— What performance metrics drive shareholder value?

[1] https://www.lawinsider.com/dictionary/section-16-officer#:~:text=Section%2016%20Officer%20means%20a,with%20respect%20to%20the%20Company.

— What behaviors are needed to drive/support?

— Which metrics can the participants have the most impact on?

— What metrics can be accurately measured?

— Which of these measures are best suited to incentive plans — measurable, reliable, controllable, transparent?

In addition to "stretch" financial goals and a demonstratable difference between the KEIP and existing annual incentive plans, the court, U.S. Trustee and creditors typically look to the company to provide a market analysis of relevant comparable companies which have also completed the restructuring process and had plans approved by the court to support the reasonableness of the proposed KEIP performance targets and payouts.

Effective market analysis to gain approval of a KEIP plan should include three key components:

1. A clear outline of existing and historical compensation plans — base salary, target and actual annual incentive payouts plus the value of any long-term incentive plans (target annual grants and/or annualized projected values,) to determine an accurate total compensation projection. Target and historical total compensation levels can be used to show the reasonableness of proposed total compensation, including the KEIP payouts.
2. A market analysis of other relevant companies on all elements of executive compensation — base salary, annual incentive payouts plus long-term incentive plans. This market analysis is to develop a baseline of market compensation for the KEIP participants, and to identify the "gap" between existing plans and the projected compensation delivered through the performance-based KEIP plan.
3. A specific analysis of projected KEIP payout amounts by participant to a set of "comparable" companies. These companies are considered similar with respect to size and business type and which have been through a restructuring process and had their plans approved in-court. This comparison focuses on key metrics such as plan size/cost, number of participants, relevant financial metrics and "fit" within the market analysis.

Implementing a KEIP plan requires significant work with company advisors to determine eligibility, timing of payments and KEIP performance metrics. Often this is an iterative process between senior management, the Board of Directors, DIP Lenders, Secured Creditors, Official Committees and the U.S. Trustee to reach final approval.

As the restructuring process moves to completion and emergence, companies typically implement a Management Incentive Plan ("MIP"), which is an equity-based long-term plan designed to align the management team with shareholders' interests and to reward them for the successful execution of the new business plan. The goal is success-sharing across the executive and shareholder groups.

MIP plans are critical for retaining and motivating top talent at emergence for a number of reasons:

1. Previous equity awards have likely lost their value through the Chapter 11 process.
2. The new MIP Plan is based on the revised business plan with the executive team and the new investors aligned around the future opportunity for both groups.
3. The new MIP plan includes specific performance measures designed to focus the senior team on building company value post-emergence.

The process of implementing a new MIP plan in place at the time of emergence from Chapter 11 requires significant work with the newly formed Board of Directors, utilizing a similar market analysis and recommendation process to KEIP design — a summary of historical company long-term incentive award practices, a complete total compensation market analysis indicating market "fit" for any proposed new equity grants and a projected total cost/dilution analysis of the new MIP for shareholders.

Based on the new business plan, the MIP also requires significant work with advisors and the new shareholder group to reach agreement on key plan elements. Historical long-term incentive awards and market practices can help determine:

— Equity plan size (% of shares outstanding allocated to the pool);

— Eligibility to participate;

— Size of emergent grant vs shares reserved for future grants;

— Type of equity to be granted (stock options, restricted stock, performance shares, etc.);

— Vesting period;

— Performance metrics if not time-based vesting.

In addition to any Executive Compensation plans put in place prior to (pre-petition), while in Chapter 11 (KERP, KEIP) and at the time of emergence (MIP), the executive team also faces a number internal Human Capital and Executive Compensation related issues that the restructuring process highlights:

— Executives have usually joined the organization at different times prior to, or during the restructuring process; are the terms and conditions of employment agreements harmonized across the executive team?

— Are there any prior executive agreements/ contracts that need to be addressed, corrected, or modified in this process?

— Members of the senior team may choose to leave during the restructuring process; are the terms and conditions of any replacement executives consistent with existing agreements in place for other senior executives?

— If emergence is achieved via a sale of the company, — are other executive compensation plans, such as severance benefits, adequately structured if there is a planned departure of senior team members?

The restructuring process drives highly critical executive compensation choices. Almost all these choices are focused on talent retention and motivation — and all of them require a thorough analysis of market practices, trends and comparable compensation levels and projected costs. Future programs also require alignment of programs with the revised business plan, a newly constituted board of directors and shareholder goals and objectives.

In summary, the critical executive decision points during a restructuring are what happens with executive compensation programs prior to, while in Chapter 11 and at emergence. Section 503 of the Bankruptcy code provides the general standards that programs must comply with — however, there is significant flexibility to design programs for each of these three phases.

4 LIQUIDITY: KEY TO RESTRUCTURING

FINANCIAL ADVISOR PERSPECTIVE

FTI Consulting

Christine Kim, *Senior Managing Director*

Tim McDonagh, *Senior Managing Director*

"Cash is King" — there is no situation where this statement is truer than in a restructuring context. A business restructuring can be precipitated by many factors but ultimately liquidity is a key factor in the restructuring process and outcome. As such, every restructuring scenario starts out with assessing liquidity, both short-term (the ubiquitous 13-week cash flow) and long-term. All constituents involved, especially lenders and other creditors, will have keen interest in the company's liquidity, as it can significantly impact the timeline and dynamics of the restructuring process. A sudden or unanticipated shortfall in liquidity without the prospect of accessing capital can force a company to file a "freefall" bankruptcy; whereas ample liquidity can provide time and control to effectuate an out-of-court solution or an expeditious filing and exit. Various constituents, each with their own agenda, will jockey for position to influence or control the restructuring, but liquidity is one of the most critical factors in determining restructuring options for a company. This chapter discusses potential liquidity pressures and sources of liquidity, and their impact on the restructuring process.

Causes of liquidity pressures

Liquidity challenges can come from many places, sometimes simultaneously, for a company experiencing distress — losses from operations, supplier payment pressures, debt service obligations, and a host of other demands — which often compels a company to effectuate an out-of-court restructuring or a Chapter 11 filing. Understanding where the risks are, managing those risks, and stress-testing a liquidity forecast under various scenarios can make the difference between an orderly restructuring and an unplanned Chapter 11 filing.

For many struggling companies, poor business performance is the underlying reason why a restructuring may be necessary in the first place. Poor financial performance not only worsens leverage metrics but can drain a company's dwindling liquidity when it is losing money from operations or cannot cover fixed charges out of operating cash flow. In many industries, poor financial performance can be exacerbated by significant seasonality factors, where sales in a slow season are not sufficient to cover underlying costs, and/or the timing and level of the working capital build for the busy season puts additional strain on liquidity. Cash flow modeling that incorporates seasonal variances and their impact on working capital is a critical component of liquidity management.

For a distressed company, a potential loss of key customers can put additional pressure on financial performance if it cannot properly service them. Customers concerned about timely product flow can move their business to competitors. If industrywide problems exist, customers might also slow down their payments due to their own liquidity issues or in anticipation that the company may be heading for a filing, and perhaps going out of business.

One of the most common causes of liquidity issues for a company is supplier pressures regarding payment terms. Many industries today operate with little inventory cushion to effectively manage working capital, which means a continuous supply of product is critical to servicing customers. From suppliers' perspectives, several clues can inform them of a pending financial crisis in a company — (i) out of the ordinary slowdown in payments, especially if not caught up quickly; (ii) financials that show persistent losses; (iii) going concern audit opinion; (iv) ratings downgrade on debt; or (v) marketplace rumors that a company is exploring restructuring alternatives or retaining restructuring advisors. With these indicators, suppliers can take material actions to limit their financial exposure and to demand payment. They can impose protective measures such as (i) a reduction in trade terms, often to cash on delivery or cash in advance, which can have significant impact on liquidity; (ii) a reduction in overall credit limits, which effectively requires a company to make more frequent payments to stay compliant; or (iii) a request for collateral either in cash-on-account or a letter of credit. In addition to merchandise suppliers, other suppliers may also look to protect any unsecured exposure; expect to get collateral requests for self-insured workers compensation liabilities, surety bonds, and cash management banks.

The other most common cause of a liquidity challenge, often entangled with poor business performance, is excessive leverage. Leverage can further drain liquidity through scheduled interest and principal payments that cannot be covered from operational cash flow. In addition, financial underperformance can further impact access to liquidity if an ABL lender imposes a block on availability against the borrowing base or triggers an appraisal update which could reduce effective advance rates.

These liquidity challenges can deeply strain the cash flow of any organization, necessitating the need for a timely, effective resolution. There are costs and benefits of effectuating the resolution through an out-of-court or in-court restructuring process. In working with an advisor, directors and officers should critically evaluate the best path forward for their organization.

Post-Chapter 11 filing

When a company restructures via a Chapter 11 filing, the liquidity picture changes quite drastically. Once the company files, it will be afforded the benefit of the automatic stay provision of 11 U.S.C. § 362(a) of the Bankruptcy Code, where all pre-petition obligations are stayed, and creditors and lenders are not able to pursue remedies for non-payment without a lifting of the stay from the court, which is rare. However, post-petition expenses and payables must be paid timely under ordinary terms. The company's liquidity needs are typically supplemented by debtor-in-possession ("DIP") financing which provides the capital to operate the business while in Chapter 11.

The direct costs of a Chapter 11 filing can also place a significant burden on a company's cash flow. There are costs of restructuring professionals, including advisors to lenders and unsecured creditor committees and other committees approved by the court, as well as incentive compensation or retention programs for key employees who are critical to the success of the restructuring and the ongoing business. There are a host of other liquidity considerations in a Chapter 11 filing, such as utility deposits and critical vendor payments. A sound DIP forecast should reflect all such needs on a timely basis to ensure a smooth restructuring process.

Sources of liquidity

With liquidity pressures coming from all sides, it is critical to explore every avenue to maximize liquidity both strategically and tactically. Although some similar liquidity generating strategies are employed between a pre-filing, out-of-court or post-filing situation, there are different considerations when a company files Chapter 11.

Pre-filing or out-of-court

Payment terms extended by vendors and suppliers are a source of short-term financing for most businesses, that is, merchandise is received (and perhaps sold) days or weeks before payment is due. Typically, one of the first ways companies extend liquidity is by stretching payables with suppliers. If managed prudently, stretching payables can provide a significant source of liquidity, but it is not a permanent solution. There is a fine balancing act, as stretching suppliers too far or for too long can compel suppliers to tighten terms or to stop providing products or services altogether, especially if there is a limited number of alternative suppliers. Stretching payables is a short-term measure that needs to be tailored to a company's situation and it's the breadth of its supplier base; it requires careful management to understand the criticality of a supplier to the business, and of the business to the supplier, and to understand the relationship with other suppliers. A blanket policy of stretching all suppliers is more likely to trigger negative consequences for the business.

Suppliers are not the only potential source of cash from working capital; more aggressive accounts receivables management is also worthy of consideration. A company should look at collection procedures, discounts offered for faster payments and past due balances to reduce outstanding receivables and accelerate collections, particularly for categories that are ineligible on the borrowing base. Inventory can also be a source of cash either through the monetization of excess or obsolete inventory, particularly if it is ineligible on the borrowing base, or through tighter management of inventory levels, which can reduce purchases.

Headcount and expense reductions are another source of liquidity. Obviously, it is important not to "cut to the bone," which may inflict irreversible damage on the business. In fact, critical investments should continue to ensure the business survives the restructuring. Judgements as to what qualifies as "cutting to the bone" and the critical needs of the business may differ among lenders, creditors, and equity holders. Working with the lenders, creditors and other key stakeholders on these actions may go a long way in ensuring a smooth restructuring process.

Another potential source of liquidity is the sale of non-core assets. It could be something as small as a bulk sale of excess or obsolete inventory or a larger transaction, such as a sale of a division or a brand. In a larger, more strategic sale, consideration must be given to whether a sale during a restructuring is the right time or if higher proceeds can be generated after the restructuring to avoid perception of being a distressed seller. Timing is also a consideration; a sale process can take a significant amount of time and often a company and its advisors can pin hopes that an out-of-court asset sale will resolve its leverage or liquidity issues, only to find out too late that the market is not receptive to the sale. Additionally, the sale might not generate needed liquidity, as there may be legal requirements to pay down debt with proceeds, or it could reduce the company's borrowing base. If the sale is conducted outside of Chapter 11, management should seek advice from its restructuring counsel to understand and mitigate potential challenges, such as fraudulent transfer, from the key creditors. Furthermore, potential buyers for significant assets maybe leery of closing a sale outside of Chapter 11 due to the absence of free and clear protections afforded a buyer in a sale under a Chapter 11 filing.

Exploring capital solutions is a more permanent source of liquidity. Often, in a distressed situation, a company is not able to pay interest and/or principal payments. One of the first tasks when debt servicing is unachievable is to enter into a forbearance agreement with the lenders to provide breathing room for the company and to work together with lenders to develop a restructuring plan. The plan may include an execution of operational initiatives, sale of all or parts of the company, an amendment to the credit agreement typically with some form of capital injection or refinancing of the debt depending on the conditions of the credit markets. If there are significant unencumbered assets, there may be an ability to utilize these assets to generate incremental capital or use as a bargaining chip in an amendment or refinancing. Another source of capital may be additional investment by equity investors, particularly PE sponsors, who see long term value in the company, especially if a liquidity crunch is viewed as temporary. Typically, whether in an out-of-court or in-court restructuring, lenders, other creditors, and equity holders are jockeying to enhance their bargaining position in the process. Not surprisingly, parties who step up to inject additional capital have material influence on the restructuring, where their goal is to control the process and enhance their ultimate position in the capital structure. This can get complex and contentious especially if there are multiple tranches of debt with cross-over holders who have different economic interests and a sophisticated private equity sponsor.

Post-Chapter 11 filing

When a company effectuates a restructuring through Chapter 11, certain pre-filing liquidity sources may not be available. For instance, a company must timely satisfy post-petition payment obligations to creditors and cannot stretch payables once it has filed Chapter 11 though its pre-petition payables are generally stayed, which is a spontaneous source of liquidity. While a company may seek to pay part of its pre-petition obligations to suppliers under one of several first day orders (e.g., critical vendor order, foreign vendor order), these payments are generally only made in exchange for normal or favorable post-petition trade terms, and they generally cover a limited number of suppliers. From a trade credit perspective, liquidity is often generated after filing for Chapter 11 due to the automatic stay provision.

One of the most significant sources of liquidity in a filing is the access to DIP financing. DIP financing can provide many lender protections that may make credit available to a borrower in Chapter 11 that they would not be able to secure outside of a filing. Some of these lender protections are super-priority status above other administrative claims; a security interest in unencumbered assets, the ability to have significant control over the Chapter 11 case through the DIP budget, or case milestones included in a credit agreement while being protected from lender liability claims that might exist outside of a Chapter 11 filing; the ability of lenders to extend additional protections to other pre-petition loans through a roll-up; or, while less common, the ability to prime other secured debt. For instance, a lender can exert greater control over a company's actions in Chapter 11 than it can through covenants outside of court, through a DIP budget a lender can exert control over the types of disbursements a company may make negotiating the amount of pre-petition claims that may be paid through first day motions, or through case milestones a lender can enforce the timeline for the sale of a company or a plan of reorganization which allows These are all subject to negotiations with the Debtor, unsecured creditor committees and other constituents but can offer DIP lenders greater control over the bankruptcy process once a filing has occurred. Another lender tactic that has become more common over the past 15 years is the roll-up DIP, where lenders can have their pre-petition debt rolled into the DIP facility along with a new money DIP loan. This grants the pre-petition debt a super-priority status and makes it much more likely to be paid off in full in most instances. All these reasons can make it easier for a company to raise new money in Chapter 11 that may not have been available outside of court, provided it has sufficient unencumbered assets.

Sale of non-core assets in bankruptcy under the court's 363 asset sale provision affords a debtor with the ability to conduct an auction sale of the business, which provides an opportunity to improve sale prices and/or terms and conditions of the sale. The process is also more attractive to buyers as it permits the sale of a debtor's assets free and clear of liens and other encumbrances. However, the company may not have access to the sale proceeds; allocation of the proceeds will need to be negotiated among stakeholders prior to the launch of the sale.

Securing liquidity requires a distressed company to look inward and outward. Executing on these liquidity source considerations, whether or not it is done in Chapter 11, puts significant strain on the company and its suppliers, customers, and employees. It is critical to work with advisors to mitigate the stress and expeditiously effectuate an orderly restructuring process.

Conclusion

Undergoing a restructuring is a challenging, stressful process for all parties involved. Liquidity is not only the lifeline of a business, but also drives the restructuring timeline and process. There may be numerous liquidity strains during a period of crisis but there are short-term and longer-term measures available for a company to “live to fight another day.” If managed correctly, a company emerging from a restructuring should have sufficient liquidity backed by a right-sized capital structure and a viable business plan. Although restructuring requires a lot of hard work, stay focused on the ultimate goal — a stable, healthy company primed to compete and grow.

5.I THE RISE OF THE RSA: DRIVING VALUE TO STREAMLINE NEGOTIATIONS IN A RESTRUCTURING PROCESS

INVESTMENT BANK PERSPECTIVE

PJT Partners

Steve Zelin, *Global Head of Restructuring and Special Situations*

One of the most significant developments in the distressed debt market during the past fifteen years has been the increasing use of restructuring support agreements ("RSA"s). An RSA memorializes the support by creditors of the terms of a recapitalization prior to a company entering Chapter 11, including the terms and conditions of the creditors' and debtors' obligation to support the Chapter 11 plan. The debtor receives a number of benefits from an RSA, including reducing uncertainty in creditor response to a proposed plan of reorganization, providing momentum for the debtor to negotiate the plan, and reducing the amount of time a company remains in Chapter 11. Creditors also receive certain key benefits, including setting milestones for confirmation and receiving reimbursement for the time and expense of negotiating the transaction.

The increasing use of RSAs has been accompanied by compressed case timelines. Between 2015 and 2018, close to 65 percent of companies with liabilities in excess of $50 million entered Chapter 11 with RSAs as compared to 6 percent in 2003 (Fitch Ratings, "Shrinking Length of U.S. Bankruptcies," August 2018). From the early 2000s to 2018, the average duration of Chapter 11 cases fell to less than nine months from approximately two years (Yozzo and Star, "For Better or Worse, Pre-packaged and Pre-Negotiated Filings Now Account for Most Reorganizations," November 2018).[1]

One of the key factors driving the rise of the RSA over that 15-year time period was the 2005 modifications to Chapter 11. Chief among those modifications was a statute limiting a debtor's period of exclusivity for filing a Chapter 11 plan to no more than eighteen months. Previously, this period was unlimited, subject to court approval. Given the risk that debtors could now lose control of their Chapter 11 proceeding earlier in the process, management teams and boards of directors sought to mitigate this risk by engaging with creditors well in advance of a company's need to the file for Chapter 11. While this change to the rules governing exclusivity undoubtedly played a key role in the rise of the RSA, it does not tell the complete picture. This chapter examines other significant factors that gave rise to the increased use of RSAs.

[1]https://www.abi.org/abi-journal/for-better-or-worse-prepackaged-and-pre-negotiated-filings-now-account-for-most

The rise of secured debt

Modifications to Article 9

In the second half of the twentieth century, issuance of secured debt was in steady decline. According to a National Bureau of Economic Research ("NBER") paper, "the share of secured bonds [issued] out of the total value of bond issuance declined from 79 percent in 1922 to 32 percent in 1967" (Benmelech, Kumar, and Rajan, "The Decline of Secured Debt," December 2021). This phenomenon was not only limited to the investment grade market; in 2000, only 2 percent of high yield issuance was secured compared to 17 percent in 1991 (Eric Yu, "Bank of America HY Credit Chartbook," January 2022). Many observed that certain difficulties associated with lien perfection in the United States were undermining the ability for companies to raise secured capital.

These challenges in perfecting collateral led to a significant revision to Article 9 of the Uniform Commercial Code ("UCC") in 2001, which had not been updated for 29 years. Article 9 of the UCC governs transactions involving the granting of liens on account of secured indebtedness. The revised Article 9 was the result of years of study by the American Law Institute and National Conference of Commissioners on Uniform State Laws. These changes eventually facilitated significant growth in secured debt markets, as seen in Exhibit 3. Specifically, the revised Article 9 incorporated the following changes:

(i) expanded the scope of secured transactions subject to Article 9, thus better capturing security interests on intangible assets,

(ii) simplified the process of lien perfection and registry, thus reducing overhead costs associated with the administration and enforcement of secured claims,

(iii) eased the process with which a secured creditor might foreclose on an underlying property in the case of default, and

(iv) stipulated that the law of the state where the debtor is located governs, as opposed to the law of the state where the collateral is located

(Nepa, "The Impact of Revised UCC Article 9 on the Law of Secured Transactions in West Virginia," September 2001).

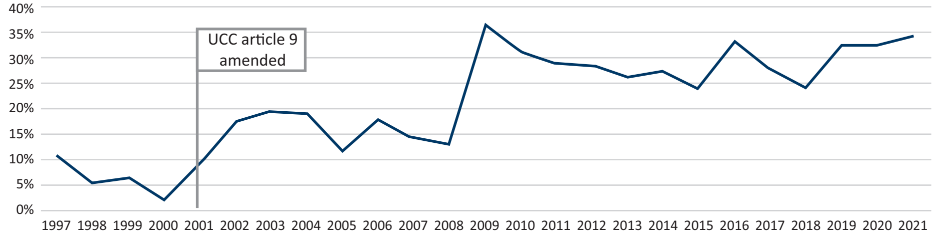
Perfecting intangible assets

The revised Article 9 also facilitated perfecting liens on intangible assets. In a series of legal decisions between 2002 and 2009, state courts nationwide established the ability to perfect liens on patents and other intellectual property, strengthening the ability of companies to issue debt collateralized by intangible assets (Mann, "Creditor Rights and Innovation: Evidence from Patent Collateral," April 2015).

The ability to perfect a lien more easily is reflected in the increasing use of secured debt. Between 2000 and 2021, secured high yield bond issuances as a percentage of all high yield bond issuances increased from 2 percent to 34 percent (Eric Yu, "Bank of America HY Credit Chartbook," January 2022).

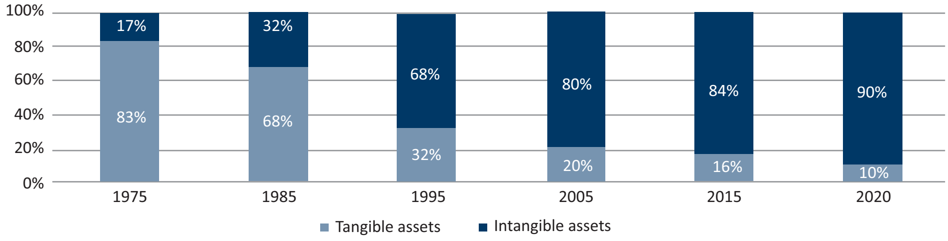
In addition, according to a 2020 report by Ocean Tomo, in 1975, approximately 83 percent of the S&P 500's value could be attributed to tangible assets,

EXHIBIT 3. Secured high-yield bond issuance as a percentage of the total high yield issuance



Source: Bank of America HY Credit Chartbook

EXHIBIT 4. Components of S&P 500 market value



Source: Ocean Tomo, "Intangible Asset Market Value Study"

a percentage which has declined to 10 percent in 2020, as seen in Exhibit 4 (Ocean Tomo, "Intangible Asset Market Value Study," July 2020).

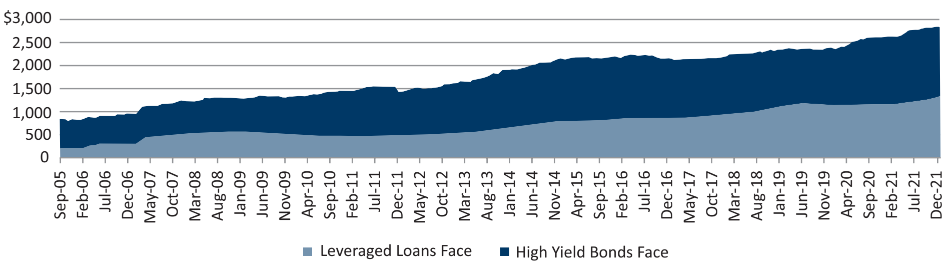
As markets began to recognize intangible asset value, lenders in secured debt markets became more comfortable making loans secured by such assets.

The maturation of the distressed debt market

Since the early 2000s, the distressed debt market has matured significantly, driven by increasing issuances in the high yield bond and loan markets. Since September 2005, the combined value of the leveraged loan and high yield debt markets increased from $862 billion to nearly $3 trillion as of December 2021 (Eric Yu, "Bank of America HY Credit Chartbook," January 2022). This transformation can be seen in Exhibit 5.

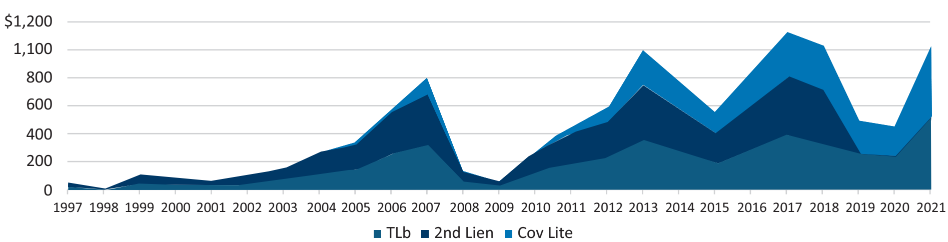
This increase was not only the result of the increasing sophistication of secured debt markets but was also driven by the concurrent rise in the number and amount of private equity sponsored transactions for which secured financing markets became a more meaningful source of capital. Since 2007, assets under management for private equity firms have increased three-fold, and in 2021, over $156 billion of high yield bonds and leveraged loans were issued to finance leveraged buyouts, as seen in Exhibit 6. (Eric Yu, "Bank of America HY Credit Chartbook," January 2022).

EXHIBIT 5. Size of high yield bond and leveraged loan markets ($ in billions)



Source: Bank of America HY Credit Chartbook

EXHIBIT 6. Leveraged loan issuance ($ in billions)



Source: Bank of America HY Credit Chartbook

As both the secured debt markets and the issuers of secured debt grew increasingly more sophisticated, companies were able to take advantage of the growing creativity of secured debt products being offered. The evolution of legal technology drove growth in companies' ability to finance specific assets in separate lending structures, carve assets from collateral pools, and raise debt under multi-tranche lien structures. Additionally, the reach for yield led to growth in the covenant-lite market, contributing to the growing complexity of capital structures.

The impact of the rise of the RSA

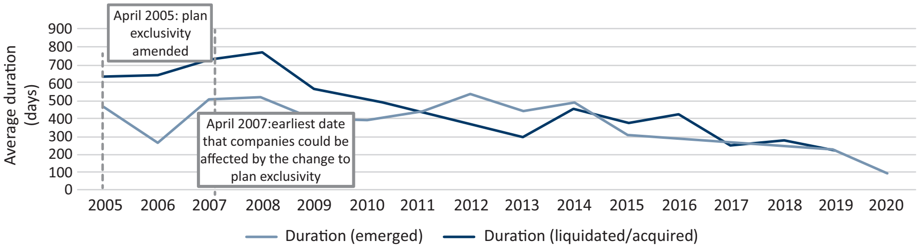
Given the enormous growth in size and complexity of the secured debt markets, coupled with the significant rights that secured creditors have in Chapter 11, the flexibility that management teams have in any Chapter 11 restructuring has meaningfully decreased. This reduced flexibility, combined with the shortened period of Chapter 11 plan exclusivity, has led to the increase in the usage of RSAs by management teams and boards.

RSAs enable both debtor and creditor parties to agree to the general outline of a Chapter 11 plan before filing, perhaps pre-empting litigation and streamlining the bankruptcy process. In general, entering into an RSA tends to result in a more efficient, less costly Chapter 11 process and reduces the uncertainty regarding support for and timing of a company's plan of reorganization and potential exit from Chapter 11. This dynamic often has the effect of reducing value erosion; for example, an RSA can protect a company from the competitive pressures that often result from a Chapter 11 filing if the distressed company can point to a concrete timeline to effectuate an agreed-upon plan of reorganization.

The most easily recognizable impact of entering into a pre-bankruptcy RSA is the significant drop in the length of time bankrupt companies typically spend in Chapter 11. According to Cornerstone Research, in 2005, companies with over $100 million in assets took roughly 400 days to emerge from Chapter 11 (Schwartz, Doyle, and Chen, "Trends in Large Corporate Bankruptcy and Financial Distress 2005 — Q3 2020," December 2021). By the 2016–2018 time period, however, the average duration of a Chapter 11 case had almost halved to 212 days. (Yozzo and Star, "For Better or Worse, Pre-packaged and Pre-Negotiated Filings Now Account for Most Reorganizations," November 2018).[2] The reduction in case duration is illustrated in Exhibit 7. It should be noted that this statistic excludes pre-packaged bankruptcies which often involve the execution of an RSA and should drive the days in Chapter 11 further downward.

An analysis of bankruptcies in fiscal years 2017 to 2021 with over $1 billion in liabilities further demonstrates the utility of the RSA, as can be seen in Exhibit 8. While companies entering a free-fall Chapter 11 with over $1 billion in funded debt took 388 days on average to emerge from bankruptcy, companies entering bankruptcy with an RSA in place took 236 days on average to emerge.

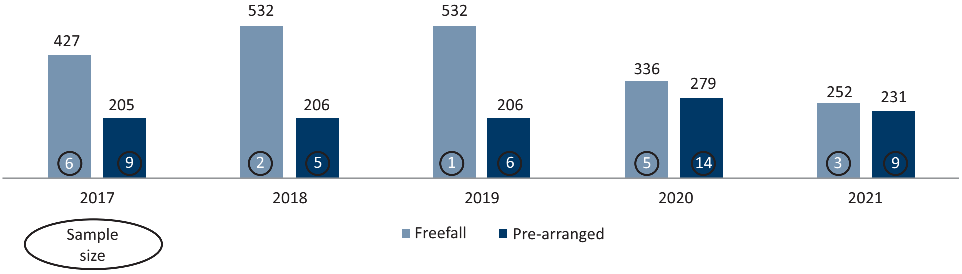
EXHIBIT 7. Average duration of Chapter 11 cases



Source: Cornerstone Research, "Trends in Large Corporate Bankruptcy and Financial Distress: 2005 — Q3 2020", 2020.

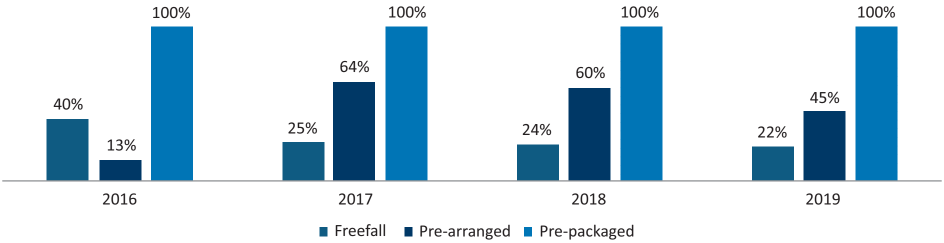
[2] https://www.abi.org/abi-journal/for-better-or-worse-prepackaged-and-pre-negotiated-filings-now-account-for-most

EXHIBIT 8. Average days spent in bankruptcy



Source: Debtwire

EXHIBIT 9. Unsecured creditor recovery by bankruptcy plan



Source: Acuris Capital Intelligence, "Bankruptcy — Fail to Prepare, Prepare to Fail"

Additionally, historical data suggests that pre-negotiated Chapter 11 plans tend to lead to higher recoveries for creditor parties (see Exhibit 9). While there may be numerous reasons to explain this phenomenon, one factor is that pre-negotiated plans tend to leave many unsecured creditors unimpaired in order to avoid the additional time and expense associated with Chapter 11 plans that seek to impair those claims. According to an analysis by Acuris Capital Intelligence, based on 2019 figures, unsecured creditors had average recoveries of 27 percent in free-fall bankruptcies, while unsecured creditors in pre-arranged bankruptcies had average recoveries of 45 percent (Acuris Capital Intelligence, "Bankruptcy — Fail to Prepare, Prepare to Fail").

The future of the RSA

The increasing use of the RSA is a trend that has had the effect of streamlining the Chapter 11 process and improving the overall efficiency of court proceedings. Given the increase in the use of secured debt, coupled with the significant rights such secured creditors have in a Chapter 11, parties to the RSA are more likely to be secured than unsecured creditors (particularly when parties believe that the value of the enterprise does not exceed the value of the secured debt).

Non-RSA creditors often raise a variety of objections, including that the RSA is a tool to rush companies through the bankruptcy process at the expense of creditors who were not party to the RSA. In response to settlements of litigation or other claims sometimes embedded in an RSA, these non-RSA creditors often argue that the litigation claims against secured creditors, owners or other third parties represent a significant opportunity for recovery that has otherwise been settled for too little value. This has necessarily resulted in unsecured creditors' committees playing a more active and frequently litigious role in an attempt to derail the settlements embodied in RSAs.

While such attempts to derail settlements reached in RSAs are not uncommon, these objections do not otherwise change the reality that companies that are able to enter Chapter 11 with the benefit of an RSA should do so. Setting the course of the Chapter 11 case from day one and providing a clear path forward by entering into a pre-bankruptcy RSA is typically beneficial to the company as well as all stakeholders. However, challenges often arise. A company should comply with the following guidelines in order to maximize its chance at executing a successful RSA:

(i) Having broad consensus on the terms of an RSA with as many parties as possible is preferred (i.e., eliminating hold outs).

(ii) For those creditors that are not party to the RSA who are likely to challenge its terms, the costs and benefits of leaving such creditors out of the settlement should be weighed. An attempt by RSA parties to allocate as little value as possible to such stakeholders when structuring the transaction could disincentivize those parties from joining the RSA.

(iii) If certain litigation is being settled in the RSA, proper investigation of such litigation by independent directors and advisors should be given due time to be completed (preferably prior to the company and its board entering into the RSA) in order to eliminate any suggestion that litigation has been settled too cheaply by RSA parties.

(iv) Providing for proper time ahead of deadlines or pending defaults in order to allow for the efficient negotiation of an RSA is recommended, particularly when incremental financing is needed. Entering into such negotiations early does not create an obligation to pursue any particular path. However, the earlier such discussions take place, the greater the opportunity to preserve value for as many stakeholders as possible. Moreover, even once the RSA has been signed, the Board should retain a "fiduciary out" to consider alternative structures in the best interests of the estate.

While there are numerous examples of RSAs that have not produced the outcomes initially anticipated (Caesars and Energy Future Holdings to name a few), in most cases, the RSAs initially entered into still provided a structure to the ensuing Chapter 11 case, helping to give rise to the ultimate settlement. RSAs, when properly structured and implemented, are an effective tool to enhance the overall success of a Chapter 11 reorganization.

Special thanks to Alec Howe, an analyst at PJT Partners, for his contributions to this chapter.

5.II THE RISE OF THE RSA: DRIVING VALUE TO STREAMLINE NEGOTIATIONS IN A RESTRUCTURING PROCESS

LEGAL PERSPECTIVE

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Throughout the past decade, the use of the restructuring support agreement (“RSA”) or sometimes referred to as “plan support agreement”) has emerged as a staple of large financial restructurings in the United States and abroad. Historically, a debtor commencing a Chapter 11 case in a U.S. bankruptcy court would use the bankruptcy process to develop a business plan, eventually file a plan of reorganization, and then work to garner sufficient support to achieve confirmation. The high costs and uncertainty inherent in these often-lengthy bankruptcy cases drove parties to employ RSAs to expedite and provide clear direction to the restructuring. At its core, an RSA acts as a “lockup agreement,” ensuring that the signing stakeholders — usually financial creditors, but sometimes shareholders or other stakeholders too — will support and not vote against a plan that is consistent with the terms of the agreed restructuring. In turn, the company agrees to prosecute the plan on the agreed-upon terms and timeline. When effectively used, an RSA can provide significant savings to a debtor’s estate and reduce the uncertainty for both debtors and creditors over the course of a restructuring.

Overview of restructuring support agreements

An RSA generally serves different purposes from the perspective of the debtor and the creditors. For the debtor, the RSA memorializes the agreement of the executing creditors to support the debtor’s proposed restructuring plan, eliminating uncertainty surrounding the company’s future. Entering Chapter 11 with an RSA also reduces potential negative implications of a bankruptcy filing by signaling to the market the debtor is positioned to successfully reorganize and exit Chapter 11 as a going concern.

From the creditor’s perspective, a restructuring support agreement provides more certainty regarding the timing and outcome of a restructuring, as well as an opportunity to potentially obtain improved economic terms, either through direct plan treatment or other fees commonly paid under an RSA.

Although RSAs are case-specific and will include varying terms, the key aspects of such agreements are outlined below.

Terms of the restructuring

A critical component of an RSA is the agreed-upon treatment of the claims of the signing creditors, as well as other key terms of the plan, such as the reorganized capital structure, the corporate governance of the reorganized company and any management incentive plan. It may also include a commitment regarding the proposed treatment of non-executing creditors.

Commitments of creditors

The RSA will bind executing creditors to vote in favor of a plan that is consistent with the terms of the agreed-upon restructuring. Creditors are also frequently bound to certain negative covenants, including an agreement not to propose or otherwise prosecute an alternative restructuring transaction and to not otherwise take any action that would impede the agreed-upon restructuring.

Since the primary purpose of the RSA from the debtor's perspective is to ensure a floor of support among executing creditors, RSAs will also typically bind creditors to restrictions on the assignment of their claims against the debtor. Generally, an RSA will provide that creditors can only trade or assign their claims against the debtor to either (1) another creditor that is already a party to the RSA, or (2) a party that agrees to sign the RSA and be bound by its terms. Absent such restrictions, a creditor could sell its claims free of the burdens of the RSA and the debtors could, in turn, lose critical support for the plan. To confirm that trading restrictions are adhered to, creditors are frequently required to report their holdings on a periodic basis or upon the request of the debtor.

Case milestones

One of the primary inducements for a creditor to enter into an RSA is certainty regarding the timing and trajectory of a case. Such commitments are enforced through deadlines, or case milestones, set forth in the RSA. The failure to meet such milestones typically creates a termination right in favor of the creditor parties. Such milestones can generally be extended on consent of the RSA parties. However, some RSAs require a super-majority of creditor support to extend milestones.

Typical case milestones include deadlines for (i) commencement of the Chapter 11 case (in the case of an RSA executed pre-petition), (ii) approval of post-petition financing and other "first day" relief, (iii) approval of a disclosure statement, (iv) confirmation of the plan and (v) the effective date of the plan. If the debtor has agreed to obtain court approval to assume the RSA, the agreement will likely include a deadline by which such assumption must be approved.

Termination rights

In addition to the case milestones, RSAs also include other rights for either the debtor or creditors to terminate the agreement upon the occurrence of certain events. Typical termination events include (i) a material breach of the agreement, (ii) conversion of the case to Chapter 7 or appointment of an examiner or trustee, (iii) entry of a court order that is materially inconsistent with the RSA (and such order is not stayed) and (iv) failure of the company to operate the business in the ordinary course.

Role of the board

From the board's perspective, the RSA is an important and useful tool in connection with any planned bankruptcy filing. As discussed above, an RSA can ensure that a company has a viable restructuring, reducing costs and uncertainty. However, because the terms of the RSA will set the stage for the entire case, it is critical that the board explore all restructuring options to ensure that the RSA is in the company's best interests.

To that end, one term that is particularly important to the board is the "fiduciary out," which enables the debtor to terminate the agreement and pursue a superior transaction.[2] An effective fiduciary out clause allows the debtor to terminate the RSA if

[1] Some versions of this provision simply allow a debtor to take — or refrain from taking — actions consistent with the board's fiduciary duties without breaching the RSA, but with no termination of the RSA itself.

the debtor determines the reorganization plan as outlined in the RSA is not in the best interests of the company. Because creditors may view a fiduciary out as giving the debtor a free option on the RSA, creditors sometimes try to narrow the circumstances under which the debtor can invoke it. However, most current fiduciary out provisions invoke a common formulation that allows for broad discretion in exercising fiduciary duties.[3]

From the board's perspective, the fiduciary out ideally authorizes the board to walk away from the RSA if the board determines that performance of the agreement would be inconsistent with the board's fiduciary duties. Boards almost always obtain this provision in RSAs, though creditors will often require that any such determination be made in good faith and on the advice of counsel.[4] Creditors may also only agree to an out for materially changed circumstances, which may set up a litigation as to what constitutes those circumstances.[5]

The inclusion of an effective fiduciary out is also important in connection with the court's approval of an RSA.[6] The presence of a fiduciary out signals to the court that the RSA was not coerced, is in the best interests of the debtor's estate and was entered into with sound business judgment.

Timing for entering into an RSA

To achieve the maximum benefit of reducing the costs associated with lengthy or uncertain bankruptcy cases, RSAs should ideally be signed prior to the commencement of the bankruptcy case, which is also known as the "petition date." With the proliferation of "pre-packaged" and "pre-negotiated" bankruptcies,[7] RSAs are predominately signed pre-petition.[8]

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[2] Some more creative RSAs may have additional "fiduciary flex" provisions that expressly provide for additional options a board may take under specified circumstances, including forms of "go-shop" provisions that ensure the best possible deal for the debtor can be presented for approval to the bankruptcy court. See, e.g., *Declaration of Justin Bickle, Chief Executive Officer of Nordic Aviation Capital A/S and Chairman of the Restructuring Committee, in Support of the Debtors' Chapter 11 Petitions and Restructuring Transactions*, *In re Nordic Aviation Capital Designated Activity Company*, Case No. 21-33693 (KRH) (Bankr. E.D. Va. December 20, 2021) [ECF No. 6] describing RSA provisions for, in addition to traditional fiduciary out, a "fiduciary flex" provision to consider alternative restructuring proposals depending on changing facts and circumstances, in addition to a limited "go-shop" provision; *Declaration of Mark E. Yale, Executive Vice President and Chief Financial officer of Washington Prime Group Inc., in Support of the Debtors' Chapter 11 Petitions and First Day Motions, In re Washington Prime Group Inc.*, Case No. 21-31948 (MI) (Bankr. S.D. Tex. June 14, 2021) [ECF No. 26] describing RSA toggle between equitization restructuring and formal marketing process, subject to requirements that, *inter alia*, corporate funded debt be paid out in cash in full.

[3] See 24 Hour Holdings II LLC Restructuring Support Agreement at § 9(f) ("…if the board of directors, board of managers, or such similar governing body of any entity constituting the Company reasonably determines in good faith after consultation with outside counsel that continued performance under this Agreement would be inconsistent with the exercise of its fiduciary duties under applicable law").

[4] See Government Development Bank for Puerto Rico Restructuring Support Agreement at § 6(b)(xi), (limiting the fiduciary out to where "[t]he governing board of directors of GDB adopts a resolution determining, after consultation with counsel, that materially changed circumstances exist creating a material impediment to effectuating the Restructuring").

[5] See, e.g., *Debtor's Motion for Entry of an Order (A) Authorizing the Debtor to Assume the Restructuring Support Agreement and (B) Granting Related Relief*, *In re Security First Inc.,* Case No. 20-12054 [ECF No. 31] ("Importantly, the RSA contains a 'fiduciary out' provision. This provision ensures that, while the Debtor is contractually bound to comply with the RSA, the Debtor retains the right to pursue an alternative restructuring path in compliance with its fiduciary duties").

[6] An analysis of large Chapter 11 cases found that an average of 65 percent of the cases filed between 2016 and 2018 were pre-packaged or pre-negotiated filings, as compared with an average of 44 percent between 2010 and 2015. John Yozzo & Samuel Star, *For Better or Worse, Prepackaged and Pre-Negotiated Filings Now Account for Most Reorganizations*, 37 Am. Bankr. Inst. J., No. 11 (Nov. 1, 2018), https://www.abi.org/node/269843.

[7] 61 percent of 2021 Chapter 11 filings of debtors with at least $250 million in gross debt (based on Reorg Research data) entered Chapter 11 with a live

Pre-petition RSAs

For a pre-packaged bankruptcy — where the debtor has both negotiated and solicited votes on a plan before the commencement of a Chapter 11 filing — the RSA is generally executed before solicitation and without court approval. Because it is expensive and time consuming to solicit a pre-packaged Chapter 11 plan, many companies will only do so if they are confident they can consummate the restructuring with the support of the creditors executing the RSA. For a pre-negotiated (i.e., "pre-arranged") bankruptcy — where the debtor has negotiated the terms of a plan, but there has not yet been a formal solicitation of votes — the RSA is generally executed shortly before the filing.

Key factors affecting the timing of an RSA include the debtor's liquidity — or other circumstances affecting the urgency of bankruptcy protection — and the nature of the debtor's relationship with key constituencies prior to the commencement of a bankruptcy case. For example, a debtor commencing a "free fall" bankruptcy — i.e., where the debtor files for bankruptcy without any agreement with its creditors — usually does so with the primary purpose of preventing a rapid dissipation of enterprise value because of foreclosure or other creditor remedies. In these cases, there is rarely sufficient time or attention for a debtor to negotiate a restructuring prior to commencement of the case. Likewise, an RSA may not make sense if a debtor needs to file for bankruptcy because it faces distress from non-financial creditors such as tort claimants, which may require the automatic stay and other features of Chapter 11, like a Tort Victims Committee, to reach a global consensus on a restructuring. In contrast, a company with sufficient cash on its balance sheet and an effective working relationship with key creditors, notwithstanding its insolvency or impending default, often has additional runway to negotiate an RSA prior to the commencement of its case.

Post-petition RSAs

Even without the benefit of a pre-petition RSA, debtors can still benefit from signing an RSA after the petition date if the court approves, providing certainty and ensuring a viable exit from bankruptcy.[9] A debtor may also sign-up certain creditor constituencies to an RSA prior to bankruptcy but negotiate a separate support agreement with other groups during the pendency of the bankruptcy case. Of course, the more stakeholders signed up to an RSA at the outset of a bankruptcy case, the easier, quicker and more economical the proceedings will be.

Pre-petition RSAs as executory contracts

As noted above, entry into a pre-petition RSA can provide substantial benefits to a debtor by streamlining a Chapter 11 process and reducing uncertainty from the outset of a case. However, a pre-petition RSA provides less certainty to creditors because it may not be enforceable against the debtor in bankruptcy. Because a pre-petition RSA will have material performance obligations remaining from all parties at the commencement of the bankruptcy, it is likely an executory contract enforceable against the counterparty during bankruptcy but subject to rejection by the debtor. As a result of this asymmetry, creditors party to pre-petition RSAs will often demand that the debtor assume the RSA to ensure enforceability.

Even without assumption, an RSA may provide other benefits to creditors, including ensuring the board's and management's support for a plan of reorganization, thereby creating momentum toward the completion of the negotiated restructuring. This momentum and the cost to the debtor of abandoning a deal can provide sufficient comfort to creditors when weighed against the cost of assuming an RSA that will typically remain subject to a fiduciary out. Additionally, financial creditors may have other levers of influence upon the Chapter 11 case, like case controls and covenants in debtor-in-possession financing, which may provide sufficient comfort to an RSA signatory that it can ensure the plan ultimately conforms to the RSA without its assumption by the debtor.

pre-petition RSA; just under half (44 percent) were pre-packaged cases.

[8] RSAs signed during a Chapter 11 case are sometimes referred to as "plan support agreements." They are functionally the same thing as a restructuring support agreement.

A motion to assume an RSA is typically subject to the business judgment standard.[10] But these motions can precipitate litigation over the proposed restructuring attached to the RSA. The objections to an RSA may cover the same ground that objections to a proposed plan will cover. Thus, assumption may simply provide another earlier bite at the apple for objecting parties to attack a deal for maximum leverage in negotiations.

Pre-petition RSAs negotiated with related or otherwise interested parties can face heightened scrutiny from a bankruptcy court.[11] For example, in *In re Innkeepers USA Trust*, the bankruptcy court declined to permit a debtor to assume an RSA where the RSA bound the debtor to favor certain secured creditors deemed to be not disinterested in the transaction.[12]

Approval of post-petition RSAs

A post-petition RSA would be subject to approval under section 363 of the Bankruptcy Code, which requires a debtor to seek court approval of any transaction that uses, sells or leases property of the estate and would occur "other than in the ordinary course of business."[13] The standard of approval is similarly deferential to the debtor's business judgment, unless conflicts or other circumstances necessitate heightened scrutiny.[14]

The enforceability of a post-petition RSA requires a fact-intensive analysis and may be problematic because of potential violations of the requirements of section 1125(b), which prohibits solicitation of votes on a plan before the court approves a disclosure statement. In one decision, the Delaware Bankruptcy Court in *In re Indianapolis Downs, LLC* held that it could enforce a post-petition RSA where the creditor parties to the agreement are sophisticated and fully informed and are required to vote on a plan only after receiving a court-approved disclosure statement.[15]

Other legal issues facing RSAs

In addition to the key terms outlined above, RSAs also often serve as a vehicle for delivering other economic benefits to executing creditors. For example, non-pro-rata backstop or other fees to certain creditor parties to RSAs are common and sometimes feature in disputes involving RSAs. Creditors left out of equity backstop financing arrangements, and the frequently valuable economics associated therewith, often challenge such fees embedded in RSAs on several grounds, including that they are improper uses of estate resources and result in inequitable treatment of creditors.[16] In addition, unsecured creditors who sign an RSA often seek to have their professionals compensated by the estate under the RSA. Courts may require the creditors to show they made a "substantial contribution" prior to approval of such fees.[17]

[9] A court will grant a motion to assume a pre-petition RSA "upon a showing that the debtor's decision to take such action will benefit the debtor's estate and is an exercise of sound business judgment." *In re Genco Shipping & Trading Ltd.*, 509 B.R. 455, 462 (Bankr. S.D.N.Y. 2014).
[10] See 7 Collier on Bankruptcy ¶ 1108.07 (Richard Levin & Henry J. Sommer eds., 16th ed. 2015), (…"[c]ourts have employed what has been described as a 'sliding scale' of scrutiny, with the most searching standard of review being accorded to…transactions in which there is a potential for managerial self-dealing").
[11] 442 B.R. 227, 231 (Bankr. S.D.N.Y. 2010).
[12] 11 U.S.C. §363(b).
[13] See *In re Residential Capital, LLC*, 2013 WL 3286198 (Bankr. S.D. N.Y. 2013).
[14] 486 B.R. 286 (Bankr. D. Del. 2013).
[15] See, e.g., *Objection of GMO Credit Opportunities Fund, L.P. and Glob. Credit Advisers, LLC to Debtors' Motion to Approve Backstop Commitment Agreement*, *In re Bonanza Creek Energy*, Inc., No. 17-10015-KJC (Bankr. D. Del. Feb. 3, 2017) [ECF No. 224]; *Objection of the Mangrove Partners Master Fund, Ltd. to Debtors Motion for an Order Approving Backstop Commitment Agreement*, *In re Peabody Energy Corp.*, No. 16-42529 (Bankr. E.D. Miss. Jan. 12, 2017) [ECF No. 1961]; *Objection to Motion for an Order Authorizing the Debtors to Enter into Backstop Agreement*, *In re CHC Grp., Ltd.*, No. 16-31854 (Bankr. N.D. Tex. Nov. 10, 2016) [ECF No. 1164].
[16] In a widely noted bench ruling on December 14, 2020 in *In re Mallinckrodt PLC*, Case No. 20-12522 (JTD) (Bankr. D. Del.), Judge Dorsey applied the "substantial contribution" standard to a request for reimbursement of unsecured creditor fees pursuant to a pre-petition RSA (not yet assumed). Judge Silverstein in *In re Boy Scouts of America and Delaware BSA, LLC*, Case No. 20-10343 (LSS) (Bankr. D. Del.) issued a similar oral ruling on August 19, 2021, applying the same standard to fees to be reimbursed pursuant to a post-petition RSA.

6.I BANKRUPTCY FINANCING: OVERVIEW AND CURRENT DEVELOPMENTS

INVESTMENT BANK PERSPECTIVE

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A company in the midst of a restructuring process often requires access to incremental liquidity to bridge to a transaction. If such transaction is implemented through a Chapter 11 filing, the bankruptcy code provides the company with the ability to obtain post-petition financing in the form of a debtor-in-possession ("DIP") loan. These loans typically benefit from a super-priority lien that is senior to all of the debtor's pre-petition liens. In addition to lien priority, DIP lenders are often given material influence over the case through case milestones, financial covenants and various other provisions that may influence the direction of the debtor's case.

This chapter will focus on recent developments and themes in DIP financing. While 2020 saw a significant increase in the volume of DIP financings due to the COVID-19 pandemic, we have narrowed our focus to review themes prevalent in DIP financings of more than $500 million that were provided in 2020–2021. The topics that we discuss include the continued prevalence of roll-up DIPs, the use of convertible DIPs (including those convertible into exit financing or post-reorganization equity), the prevalence of DIP motion objections from pre-petition lenders proposing their own alternative DIP and recent pricing trends in DIPs.

Before going into these topics, while not technically a DIP facility, it is worth discussing the financing proposed in the early stages of Hertz's Chapter 11 case. Hertz filed for Chapter 11 on May 22, 2020, early in the COVID-19 pandemic. Within two weeks of the filing, fueled by significant interest from retail investors on Robinhood and elsewhere, Hertz's share price rose from $0.56 to $5.56 per share. Sensing a unique opportunity, Hertz took the unusual step of immediately seeking bankruptcy court approval to raise up to $1 billion through the sale of common equity to help fund its Chapter 11 case, with the sale to be effectuated via a pre-existing shelf registration. The bankruptcy court quickly approved the motion pursuant to Section 363(b), which allows a debtor to sell assets outside of the ordinary course of business with court approval. Following significant press coverage questioning the long-term value of Hertz's stock, as well as the debtor's own admissions of the difficult operating conditions it was facing, the U.S. Securities and Exchange Commission ("SEC") intervened through the provision of extensive comments on Hertz's offering disclosure.

In the face of pressure from the SEC and "meme" stock allegations, Hertz pulled the prospective equity offering. At the time of the proposed equity raise, many market observers considered this to be the correct outcome, arguing that Hertz was nothing more than an overvalued or valueless "meme" stock. In hindsight, however, the Robinhood traders may have been correct after all. Hertz emerged from Chapter 11 on June 30, 2021, with a plan that paid all creditors in full and provided approximately $1 billion in recovery to existing Hertz shareholders. Since emerging from Chapter 11, in the midst of an economy emerging from COVID-19, Hertz's business has flourished and its valuation has increased markedly.

Prevalence of roll-ups

Many DIP facilities include a roll-up component in which a portion of pre-petition debt is "rolled" into the DIP facility. In such instances, a pre-petition lender's loan will be either repaid with proceeds from a new post-petition financing or converted into a post-petition DIP loan. Typically, the "rolled" loan is afforded a lien junior to the new money DIP, but remains senior to all other liens. Consequently, roll-ups improve the priority position of the pre-petition lender and provide the lender with many of the benefits that a DIP lender enjoys.

Although a roll-up DIP does not provide the debtor with any additional liquidity in and of itself, it is an increasingly important feature that many pre-petition lenders will require as consideration for providing new money DIP financing. In as much as the roll-up does not provide any new liquidity, the terms of the roll-up equity are often highly contested issues in a debtor's Chapter 11 case. Frequently, an important factor in analyzing the size of a roll-up is the amount of roll-up dollars vs. the amount of new money dollars being provided.

Out of the 18 DIP financings we reviewed, 11 cases included DIP facilities that contained a roll-up component — including instances in which proceeds from a new money DIP facility were used to repay a pre-petition debt facility or replace pre-petition letters of credit. In these 11 cases, the average amount of roll-up that was approved was 0.83 times the amount of new money the DIP facilities provided. In other words, for every dollar of roll-up DIP approved, there was approximately $1.20 of new money provided. Further, approximately 64 percent of the cases had new money components equal to, or greater than, the amount of the roll-up. There were four cases in which the amount of roll-up exceeded the amount of new money being provided. Perhaps the two most aggressive roll-ups that were approved can be seen in the cases of Tailored Brands and American Commercial Lines. In each case, the amount of pre-petition debt that was rolled-up, including replaced letters of credit, was three to four times the amount of effective new money that was provided by the DIP facilities. Although we expect the prevalence of roll-up DIPs to continue, the unique and uncertain operating environment created by the COVID-19 pandemic likely led to more aggressive and lender-friendly roll-up terms than we will see in a more normalized environment.

Convertible DIPs

While the Bankruptcy Code requires that a DIP facility be repaid in full with cash upon emergence, some DIP financings are structured to provide for the conversion of all, or a portion of, the DIP obligations into either exit debt financing (a "DIP-to-Exit") or reorganized equity upon emergence (a "DIP-to-Equity," and, collectively, a "Convertible DIP"). The clearest benefit to a debtor from obtaining a Convertible DIP is that such a facility reduces the risk that the debtor is not able to source the liquidity required to fund a repayment of the DIP upon emergence. Given the uncertainty in both a debtor's business operations and the debt financing markets created by the COVID-19 pandemic, Convertible DIPs were utilized in several Chapter 11 cases in 2020.

Three recent cases that contained DIP-to-Exit facilities were Tailored Brands, Denbury Resources and Ascena Retail Group. All three cases were filed with restructuring support agreements ("RSAs") in place with the support of a sizeable portion of the companies' creditors. The benefit of a DIP-to-Exit was clearly evident in both Tailored Brands and Denbury Resources, with the time from filing to confirmation being only approximately three months and approximately one month, respectively. Ascena Retail was initially expected to be a four-month case, driven primarily by the time required to run post-petition sale processes for several non-core assets. However, the debtor's case strategy shifted materially to a full sale of its assets and, as such, the case took approximately seven months to be confirmed.

Although less commonplace, there were several notable cases that utilized DIP-to-Equity facilities. These structures can be attractive if lenders believe there will be material underlying value in the reorganized business and want to participate in the potential upside. One such example can be seen in the bankruptcy of Grupo Aeromexico, which filed for Chapter 11 on June 30, 2020. In that case, the debtor obtained a $1 billion DIP facility structured as a $200 million new money tranche A term loan and $800 million new money tranche B term loan. Tranche B contained an equity conversion feature pursuant to which the lenders could elect to convert their DIP claim, plus fees, into reorganized equity at the plan value.

In the case of LATAM Airlines Group, the debtor initially filed a motion for approval of a DIP facility that contained an equity conversion feature in one of its multiple tranches. The proposed DIP contained a $1.3 billion tranche A facility and a $900 million tranche C facility. As proposed, the tranche C facility gave the lenders the ability to elect to be repaid with reorganized equity issued at a significant discount to plan value. The equity conversion feature drew considerable scrutiny from existing unsecured creditors and a group of ad hoc bondholders who argued that the equity conversion feature was priced at too material of a discount, subverted the reorganization process and gave rise to an improper sub rosa plan. Ultimately, the debtor and the DIP lenders revised their initial DIP proposal and secured court approval for a DIP facility that did not include an equity conversion feature.

One more recent case, Philippine Airlines, utilizes both a DIP-to-Exit and a DIP-to-Equity in the same DIP facility. Specifically, Philippine Airlines obtained court approval of a $505 million DIP facility structured as a $250 million tranche A facility and a $255 million tranche B facility. At the conclusion of the case, the debtor will have the option to convert the tranche A facility into exit financing in the form of an unsecured term loan. In addition, the debtor has the option to convert the tranche B facility into 79.5 percent of its reorganized common equity.

While the COVID-19 pandemic created a situation in which the exit-financing-certainty benefit from a DIP-to-Exit facility was intensified, we expect debtors to continue to push for such terms even in a normalized operating environment. Conversely, DIP-to-Equity facilities were likely largely driven by the belief of DIP capital providers that the operating impact of the COVID-19 pandemic was temporary in nature and post-reorganization equity value would rebound materially. This leads us to believe that, other than in a limited number of situations, DIP-to-Equity facilities are unlikely to be common.

DIPs contested by lenders proposing a competing DIP

A significant development during the pandemic was the frequency with which certain company pre-petition lenders opposed DIP motions on the basis that they were willing to provide a more favorable DIP facility themselves. As laid out as follows, the reasons for objecting and proposing a competing DIP often varied. It is important to note that courts do not require a debtor to select the cheapest DIP alternative, but instead grant considerable deference to the debtor's business judgment so long as the DIP terms are "fair and reasonable" given the current set of circumstances. As a result, when there are multiple competing DIP proposals, there can be considerable disagreement over which is the "best" DIP for the debtor and its stakeholders.

In the Chapter 11 case of J.C. Penney, an ad hoc group of first lien and second lien crossholders and the unsecured credtiors' committee ("UCC") objected to the debtor's motion to approve a DIP provided by an ad hoc group of first-lien-only term lenders and noteholders. As part of its objection, the ad hoc group of first lien and second lien crossholders proposed two alternative DIP facilities. The first alternative mirrored the debtor's proposed DIP but with less expensive pricing; the second alternative contained a different structure but the crossholder group argued that it provided more liquidity to the debtor. The court heard testimony from multiple parties, during which the debtor's investment banker testified that selecting an alternative proposal could jeopardize the RSA that was negotiated in advance of the company's Chapter 11 filing. Ultimately, the two lender groups reached a settlement that allowed for increased participation in the DIP roll-up. As such, the court approved the proposed DIP from the ad hoc group of first-lien-only term lenders and noteholders.

In the Chapter 11 case of Neiman Marcus, the objection came from a first lien lender who was not participating in the DIP provided by other lenders. Specifically, Mudrick Capital Management, a term lender, objected to the debtor's motion to approve a DIP backstopped by an ad hoc group of term lenders and secured noteholders. In its objection, Mudrick Capital stated that it had reached out repeatedly to the ad hoc group of term lenders and secured noteholders to express its desire to participate in the proposed DIP facility but was "rebuffed." Mudrick Capital, with other lenders, proposed a $700 million competing DIP that they argued had superior economics. Ultimately, the court approved the debtor's DIP motion over objections lodged by Mudrick Capital, ruling that while it was "expensive money," it was the best available financing for the debtors.

In the Chapter 11 case of Valaris, the objecting parties were the pre-petition unsecured revolving lenders who opposed the debtor's motion to approve a DIP provided by an ad hoc group of unsecured noteholders. Prior to the company filing for Chapter 11, the revolving lenders were in advanced discussions with the company regarding the terms of a DIP but according to testimony from the debtor's advisor, delays in finalizing the DIP loan with the revolving lenders opened the door for discussions with the noteholder group. Again, in this case, the court ultimately overruled the objecting parties and approved the debtor's DIP motion, ruling that the incremental liquidity provided by the debtor's proposed facility was "easily worth the price difference" between the two competing financings.

Last, in the Chapter 11 case of LATAM Airlines, an ad hoc group of unsecured noteholders, led by Knighthead Capital Management, objected to the debtor's proposed multi-tranche DIP facility that was to be partially funded by certain shareholders. LATAM's DIP motion sought approval of a $1.3 billion tranche A facility provided by Oaktree and a $900 million tranche C facility provided by certain shareholders. Initially, the ad hoc group of noteholders proposed a competing $900 million tranche C facility, but eventually proposed a competing $1.3 billion tranche A facility and $900 million tranche C facility. As discussed previously, the court denied the debtor's initial DIP motion on the grounds that it constituted a sub rosa plan. The debtor subsequently amended its DIP motion removing the equity conversion feature in tranche C and opening up participation in both tranches to Knighthead and other interested lenders. As a result of these changes, the court approved LATAM's amended DIP motion. Given the increased amount of direct lending capital available in the financing market as well as the benefits and protections afforded DIP lenders, we expect a continued increase in the number of cases with lender groups providing competing DIP proposals.

Pricing trends

Despite objections over DIP pricing in many of the cases discussed previously and the presence of several competing DIP proposals, pricing trends remained largely in line with historical rates throughout the pandemic. Based on the cases we reviewed, the median spread on London Interbank Offered Rate ("LIBOR") based loans during the height of the pandemic from May 2020 to October 2020 was approximately 725 basis points. This compares with a median spread from January to February 2020 of just under 700 basis points and the only DIP of size since October 2020 (Philippine Airlines) at L + 850 basis points. It is worth noting that the same cannot be said for median yields where the median yield from May to October 2020 was approximately 13 percent as compared with a median yield of just under 12 percent from January to February 2020 and an approximately 10 percent yield on Philippine Airline's DIP facility. This was driven largely by the presence of several cases at the early stages of the pandemic containing DIPs with significant fees.

Conclusion

In conclusion, there are a number of trends we have witnessed in the DIP markets that will likely continue to prevail. The opportunity for a lender to defend its pre-petition claim through a roll-up by providing a new money DIP continues to be an attractive value proposition for lenders and one that we expect to continue. In addition, the uncertainty created by the pandemic highlighted the importance of a debtor having certainty in its ability to fund emergence — as evidenced by a number of DIP-to-Exit facilities that helped facilitate quick trips through Chapter 11.

Also notable was the prevalence with which lenders were willing to convert their DIP loans into post-reorganization equity, signifying belief in long-term equity value — likely driven by the expected temporary nature of the pandemic's impact on the business. Further, as a result of defensive DIP lending strategies, low interest rates and the abundance of direct lending capital available, we would expect the number of cases with competing DIPs to increase. While we have not yet seen it bear itself out in recent sizeable DIPs, we expect the same factors to eventually put downward pressure on DIP pricing.

6.II BANKRUPTCY FINANCING: OVERVIEW AND CURRENT DEVELOPMENTS

LEGAL PERSPECTIVE

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Overview of Chapter 11 financing

Distressed companies often face the following challenge: having devised a plan to stabilize the company, restructure its operations and/or right-size its balance sheet, the company needs time and, thus, liquidity — which it may not have — to bridge the period through a turnaround. At the same time, lenders and other traditional sources of capital may be unwilling to provide new capital to the company outside of Chapter 11 given the circumstances and credit risk. For borrowers facing this dilemma, Chapter 11 offers two unique financing solutions.

First, companies with existing cash and a projected cash flow that is sufficient to fund a restructuring, but which has been pledged as collateral for an existing financing, can use the Bankruptcy Code to access this so-called "cash collateral." This cash collateral can be used as long as the company provides the holder of the security interest over the cash with "adequate protection" of the security interest. This adequate protection can be provided in a variety of forms including cash interest, replacement liens, payment of the lienholders' fees and expenses and claims in the bankruptcy case with priority over substantially all other claims. The amount of this adequate protection can either be agreed upon between the company and the lienholder or can be ordered by the court after a hearing.

Second, a company in Chapter 11 can obtain new post-filing (i.e., post-petition) debtor-in-possession ("DIP") financing. DIP financing typically takes the form of a post-petition loan offered to the debtor company to fund the company's operations in Chapter 11 as well as the costs associated with the Chapter 11 case, such as professional fees. While the credit support for a DIP facility varies on a case-by-case basis, a DIP lender typically receives some combination of liens over substantially all of the company's assets that are senior to all of the company's existing liens (the so-called "priming liens") as well as superpriority claims in the bankruptcy case, cash interest, and payment of lender fees and expenses.

DIP financing and the use of cash collateral are not mutually exclusive alternatives; in fact, they are often utilized in tandem. For example, a subset of lenders in a bank group may provide senior DIP financing in conjunction with the use of the full bank group's cash collateral. In another instance, if a lender with liens on cash collateral is unwilling or unable to extend DIP financing, the company may seek to use the lender's cash collateral concurrently with obtaining DIP financing from a new third party. Notably, the existing secured lender may be party to an intercreditor agreement or another arrangement with more junior lenders that may restrict or condition the junior lenders' ability to extend DIP financing. As these dynamics occur with frequency in complex Chapter 11 cases, it is important for a company to actively engage with secured lenders as part of the pre-petition planning process in an attempt to build as much consensus as possible going into Chapter 11.

Obtaining DIP financing

Approval of DIP financing is typically sought in the first days of a Chapter 11 case to ease a company's transition into bankruptcy and ensure minimal operational disruptions. Usually the company seeks to obtain access to a portion of the total DIP loan (an interim amount) at the first-day hearing and then seeks further authority to borrow up to the full amount of the loan at a second-day hearing, typically held between 21 and 35 days into the bankruptcy case. Given this timeline for approval, the terms of DIP financing are often negotiated among the company, the DIP lender and the company's existing secured lenders during the weeks before the company files for bankruptcy. Given the central role of DIP financing in a Chapter 11 case, following the petition date, the company and the DIP lender will typically continue negotiating the terms of the DIP financing with any official committee of unsecured creditors (and any other court-appointed committees), the United States Trustee, and other key case constituents in order to resolve as many objections as possible.

When evaluating a debtor's request to obtain DIP financing, courts generally consider whether the terms of the DIP financing are fair and reasonable under the circumstances. In making this determination, courts will generally defer to a debtor's business judgment so long as the agreement to obtain such credit does not run afoul of the provisions of and policies underlying the Bankruptcy Code. Courts will also generally not require that the company obtain the best available or best hypothetically achievable terms but terms that are fair and reasonable given the circumstances. Against this backdrop and understanding that (a) companies negotiating for DIP financing often have limited leverage to demand more reasonable terms and (b) once approved, DIP financing becomes a critical element of any Chapter 11 case, creditors' committees, the United States Trustee and sometimes judges try to limit DIP lender influence and control by seeking to amend the terms of the proposed DIP financing. In addition to these post-petition negotiations and even after a company enters bankruptcy, offers for alternative DIP financing may be presented to the company, and a court may consider these alternative DIP financing proposals when evaluating a company's request for DIP financing approval.

As more fully described in the following section, a DIP loan provides the lender with an important voice in a company's Chapter 11 case. In addition to lucrative economics, the DIP loan often provides the lender with substantial control over the case (through milestones and other covenants) as well as other protections for, if applicable, any pre-petition claims the lender may have against the debtor. Thus, while there is no restriction on who may provide a DIP loan and third-party loans are not uncommon, DIP loans are often provided by a company's existing pre-bankruptcy creditors to protect their existing creditor positions — most often the secured lenders but also unsecured lenders.

Similarly, given their important role in a case, DIP loans are sometimes provided by the company's affiliates (including equity investors). In situations involving DIP financing provided by affiliated parties, courts will apply a higher level of scrutiny to ensure that affiliated parties are not exercising undue control of a Chapter 11 case through a DIP facility. When evaluating insider DIP facilities, courts generally look at whether independent directors or an independent committee of the company's board negotiated the terms of the DIP facility with the affiliated party and whether and to what extent alternative non-affiliated DIP financing was solicited, available and considered. For these reasons, companies in distressed situations often appoint independent directors with restructuring experience to navigate issues involving affiliates.

The central role of DIP financing in Chapter 11 proceedings

DIP loans and the court orders and financing agreements that govern them tend to become critical parts of any Chapter 11 case. Given that distressed companies often face liquidity constraints, access to DIP financing (and related use of cash collateral) becomes the debtor company's lifeblood. DIP lenders typically negotiate protections in loan documents that provide them with significant influence in Chapter 11 proceedings. These provisions include:

— **Case milestones**: Case milestones represent deadlines by which debtor companies must take certain actions in a Chapter 11 case. These typically include deadlines to obtain court approval of the DIP facility (both on an interim and final basis); deadlines related to any sale processes contemplated by the company, deadlines for the filing, solicitation, and confirmation of the company's reorganization plan and an outside/maturity date by which the company must exit Chapter 11 and repay or otherwise satisfy the DIP loan.

— **The DIP budget**: The company and the DIP lender agree to a budget, setting forth the projected operational and restructuring costs to be incurred and paid during the Chapter 11 case. These budgets vary in length but typically cover a 13-week period and are detailed by week.

— **Events of default**: DIP loan documents typically contain provisions allowing DIP lenders to terminate the DIP, demand repayment and exercise remedies if, among other things, a trustee or examiner is appointed; a company breaches its representations, warranties or covenants; claims are pursued against the DIP lender or the DIP budget or case milestones are breached.

— **Credit bidding rights**: The Bankruptcy Code permits secured lenders to credit bid their debt in any bankruptcy sale of their collateral. This means that a DIP lender, instead of paying cash for its collateral, can purchase the collateral by deeming all or a portion of the DIP loan satisfied. DIP lenders typically negotiate for credit bidding rights that are senior to all other existing secured lenders.

DIP facilities that are provided by incumbent secured lenders may also include a feature called a "roll up." In a roll-up DIP, the company borrows (or is deemed to borrow) funds under the DIP facility and repays (or is deemed to repay) pre-petition debt with the borrowed funds, thus "rolling" the pre-petition debt into the post-petition debt. The lender benefits from the roll up because the Bankruptcy Code provides enhanced treatment and protections for post-petition DIP loans compared to pre-petition secured debt. The Bankruptcy Code provides that pre-bankruptcy secured lenders may be provided with cash equal to the value of their collateral (or replacement debt with an extended maturity and different interest rate and other terms) so long as the deferred cash payments under the new debt have a present value equal to the value of their collateral. Conversely, holders of DIP obligations (which constitute superpriority administrative expenses in the company's bankruptcy) must be paid in full in cash in order for the company to confirm a reorganization plan unless the DIP lender agrees otherwise.

In light of the influence that DIP financing provides the DIP lender over a Chapter 11 case, it is critical for directors and officers of distressed companies to negotiate a DIP financing package thoroughly and extensively. Ideally, a DIP facility will provide a balance of a sufficient financial commitment to enable the company to execute on its restructuring goals without so many covenants and restrictions that the company is effectively handcuffed. While lenders will likely insist on some or all of the previously described protections, negotiating these provisions to maintain maximum flexibility is key for a company's pursuit of a successful restructuring strategy. Additionally, while distressed companies may have limited negotiating leverage outside of Chapter 11, once the company enters Chapter 11 and the company's reorganization process builds steam, the DIP lender's ability to call a default and enforce the DIP protections may, to some extent, be practically limited or influenced by circumstances, the bankruptcy court and other participants in the bankruptcy case.

Shifting dynamics in DIP financing

As directors and officers navigate DIP financing issues, it is critical to ensure that they and their advisors are fully apprised of the latest developments in DIP financing. As an initial matter, the proliferation of distressed investing and the increased competition in the high-yield debt market have driven new lenders into the DIP space. Historically, DIP loans were almost exclusively provided by a company's senior secured lender (typically a bank or a syndicate of banks). However, in recent years, distressed investors have been drawn to DIP financing for a number of compelling reasons. First, DIP lending is lucrative and secure. DIP lenders are generally able to charge higher interest rates than those for non-DIP loans of similar amounts and duration, while having the security of first-priority liens and superpriority claims approved by the bankruptcy court. Second, DIP facilities (particularly larger DIP facilities) can mirror out-of-court financings, with multiple tranches and lenders taking first-priority liens on different pools of collateral or with DIP agents syndicating participation in the DIP loan to a larger pool of lenders. All of these tools help DIP lenders distribute and minimize risk and increase the attractiveness of DIP financing to lenders. Third, given the various previously described protections afforded to DIP loans and the inherent flexibility of the bankruptcy process, DIP financing provides DIP lenders with an opportunity and leverage to seek to acquire a stake in the debtor company's assets or equity in the reorganized company. As such, while DIP financing is still largely provided by existing secured lenders, the composition of DIP lenders has begun to change. As competition for DIP lending opportunities increases, and as the pool of non-traditional DIP lenders continues to expand, directors and officers should work with their advisors to canvass a wide group of potential lenders to enable them to negotiate more favorable pricing and other terms.

Another important recent development in DIP financing is the rise of so-called equity conversion DIPs. While the Bankruptcy Code requires a DIP facility to be paid in full in cash upon the company's emergence from Chapter 11, the company and its DIP lender are free to negotiate an alternative treatment of the DIP, including the satisfaction of DIP obligations through the provision of replacement debt owed by the reorganized company or equity in the reorganized company. With increasing frequency, DIP lenders have opted to have their DIP claims satisfied through equity in the reorganized company. Indeed, some DIP lenders have recently sought, as a condition to approving the DIP facility, judicial approval of an equity conversion option in favor of the DIP lender at the early stages of a Chapter 11 case. While some courts have been reluctant to approve this sort of option at the outset of a bankruptcy case, directors, officers and companies' advisors should continue to evaluate upfront creative options for addressing DIP claims at emergence, particularly where borrowers are experiencing a cash shortage. Moreover, while an equity conversion option exercisable by the lender has drawn some judicial scrutiny, equity conversion options exercisable by the debtor company may pose fewer issues.

While DIP financing is the norm for financing most large Chapter 11 cases, there are alternative financing tools that companies can consider depending on the facts of the case. For example, section 363 asset sales (which allow a company to sell its assets free and clear of liens and claims outside of a plan) may provide companies with liquidity in lieu of, or in conjunction with, DIP financing — allowing the debtor to eliminate the need for, or reduce the amount of, DIP financing or to limit the DIP facility to a short-term liquidity bridge through the receipt of proceeds of a section 363 sale. More recently, at least one public company in Chapter 11 sought court permission to issue equity at market prices post-petition because of upward trends in their stock price during the pendency of the case. While this attempt was ultimately abandoned, it remains to be seen whether other public companies will try to capitalize on changes to their stock price in bankruptcy in an attempt to increase liquidity and reduce their reliance on DIP financing.

Conclusion

DIP financing is a critical element of most large Chapter 11 bankruptcy cases. DIP loans provide companies with much needed liquidity to finance their restructuring efforts in Chapter 11. The cost of DIP loans is the substantial protections and significant control and influence in the Chapter 11 case that DIP lenders demand. The most successful DIPs will balance a lender's need for protection and certainty with a company's need for flexibility and liquidity. Directors and officers of distressed companies will be well served to work with their advisors closely to understand the standards by which DIP facilities are evaluated, any governance issues related to a particular DIP, the various protections that they can expect DIP lenders to request, the motivations that are likely to drive potential lenders, and the latest DIP developments and DIP alternatives.

6.III BANKRUPTCY FINANCING: OVERVIEW AND CURRENT DEVELOPMENTS

FINANCIAL ADVISOR PERSPECTIVE

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Introduction

There are many reasons why an enterprise might seek Chapter 11 protection. Among them, to right-size a bloated balance sheet, to implement a strategic disposition under difficult financial or operating conditions, to manage or shed liabilities, ordinary course or unforeseen, that can't get worked out without Chapter 11 most protections, or to equitably distribute assets to competing and impatient creditors. Directors and officers of enterprises that must restructure in-court face a common problem — securing adequate liquidity runway to meet the objectives of the Chapter 11 case. Many companies enter Chapter 11 only after significant efforts to restructure and secure sources of liquidity outside of bankruptcy to avoid the costs and risks to enterprise value and recoveries that are attendant with the Chapter 11 process. Lenders, particularly those who are not lending defensively to protect pre-petition loans made to the company, however, will often avoid financing companies on the verge of failure. However, many lenders will offer financing to entities in or planning for Chapter 11 under the special provisions in the Bankruptcy Code affording unique protections to parties who extend credit to in-court debtors, commonly known as debtor-in-possession ("DIP") financing. As discussed below, this financing may come from an existing secured lender or new lenders to the situation who can get comfortable with the credit risk.

This financing is often required to evidence the ability of a debtor to get through a Chapter 11 process and to "flash the cash" to key vendors and other trade relationships who need assurances to continue transacting with the company through the process. Similarly, employees, customers and other pre-petition lenders, even if junior to the DIP, need the financial comfort of knowing there is a funded path to an ultimate recovery.

In each case, there are common predicates for securing in-court financing, and directors and officers of companies seeking a DIP loan and Chapter 11 protection must prepare for the common needs of DIP lenders to ensure the best terms and availability and the financial runway required to effect strategic goals.

Ensuring sufficient runway in advance of and during an in-court restructuring is no simple feat, and directors and officers must make sure their company's leadership and reporting capabilities are equipped to confront business exigencies that they may be unprepared for in the normal course of their careers. This often will require timely engagement of experienced financial advisors who can help train existing leadership and staff and ensure the company is prepared for the requirements of DIP lenders and to otherwise prepare the company to go through a Chapter 11 process.

Without sufficient liquidity, companies can quickly deteriorate, as customers, suppliers, lenders and other stakeholders all seek to protect themselves, and restructuring options quickly narrow as a result. Even fundamentally viable companies can face incredible demands on cash that can severely impair normal operating flexibility as they approach a restructuring. In partnership with professionals, companies should assess, develop and stress test operating and financial scenarios to ensure they can manage unique working capital challenges associated with entry into an in-court restructuring process.

Enabling Chapter 11 financing

DIP financing can afford the lender "super-priority" rights — a unique feature in the world of lending. The specific requirements and benefits are beyond the scope of this primer, but DIP financing can come from existing lenders or new entrants into the capital structure. In each instance the availability of DIP financing starts with a careful analysis of collateral — both encumbered and potentially unencumbered, representing a security package that may be offered to a lender to support a DIP. This key analysis undertaken by the company is a predicate to understanding what financing will be available to the company. Unless it can be demonstrated that existing lenders' collateral value comfortably exceeds current secured debt or that there are other unencumbered assets, a new lender will need to lend on a "junior" basis — often a tough proposition for new lenders. As well, the company will need a carefully prepared DIP budget and operating plan to approach lenders.

Existing pre-petition senior and junior lenders already have a stake in the case, and in most circumstances will have a right to consent to and condition the priming of their liens and/or use of their collateral. Pre-petition lenders often will provide DIP financing on a defensive basis to protect their existing credit exposure and thereby maximize their recovery by supporting the company as it seeks to reorganize. They will need a well constructed DIP budget that will stand up to rigorous diligence and demonstrates the ability to achieve the goals of the Chapter 11 case.

DIP loans may also be provided by a third-party lender (including a wide range of alternative asset managers) new to the company, but these are less common because of the valuation and potential litigation challenges of making a loan that ranks in priority ahead of senior creditors (a priming loan), and the added risk of extending a loan that ranks junior to existing debt. In all cases, robust and reliable data on the company's assets, unencumbered collateral, liquidity and runway, and the budgets and plans discussed above will be a predicate to engaging a new lender.

As discussed, a significant amount of work goes into structuring and sizing a DIP facility. The company and its financial advisors develop a comprehensive cash flow forecast for rolling 13-week periods that serve as the DIP Budget. This process requires carefully analyzing cash inflows and outflows during the anticipated pendency of the Chapter 11 case, including forecasting the timing of payment of vendors, seasonal variations in its receipts, essential capital expenditures during the period, as well timing features related to the Chapter 11 statutory automatic stay and approval and payment of professional fees. Once a DIP budget has been agreed upon, the company and lenders will negotiate the appropriate size and structure of the DIP credit facility to provide the company with liquidity required to restructure while holding the company accountable to its cash flow projections.

The protections afforded to DIP financing in Chapter 11 cases create an opportunity for these lenders to exert significant influence over the direction of the case from the outset, arguably before the full dynamics of the case are understood by all parties. As a result, these financings and terms are carefully examined by other creditors (including an official committee of unsecured creditors to the extent that one is formed), the bankruptcy court and the U.S. Trustee's office (an independent watchdog over the process), and one or more of these parties may have a material impact on DIP negotiations and court-approved terms. Again, careful planning and a well-constructed budget are essential to help ensure a smooth financing process and the best terms the company can obtain under the circumstances.

Issues to monitor and manage

As the company seeks to secure financing for its restructuring, there are many issues to navigate in addition to the collateral value and valuation issues discussed above. These include:

— **Intercreditor issues**: In most cases there will be tension between senior and junior creditors, who often disagree over the best path forward in a case. For example, an existing lender turned DIP lender may drive toward an expedited process that results in a timely outcome and full recovery with as little risk as possible; however, the courts may find these aggressive timelines to be unreasonable, not allowing the process to maximize enterprise value, to the detriment of junior creditors.

In all scenarios, a competitive financing process led by professional advisors will allow for the best loan terms available. Evidence of a fulsome process will be important for a judge to approve the financing proposed.

— **Financial covenants**: DIP loans will have strict reporting requirements and financial covenants around cash receipts and disbursements that could trigger a default should they vary beyond permitted levels. Since a default can result in an acceleration of the DIP credit facility (and loss of liquidity), it is critical that the company and its advisors plan for a broad range of cash flow scenarios when developing the DIP budget and covenants to ensure that that the company can maintain compliance, or otherwise create a mechanism that allows for the DIP agreement to evolve as needed over time to accommodate acceptable changes.

— **Milestone covenants**: DIP loans also often include other covenants tied to case milestones that require the debtor to make progress toward a successful resolution to the case, which are negotiated in parallel with the other terms and covenants. Examples include dates by which the company must i) file for Chapter 11, ii) obtain approval of DIP financing, and iii) obtain approval of a plan of reorganization and disclosure statement, among others. Certain DIP agreements may also specify an alternative path should certain milestones not be met. While DIP lenders will often push for aggressive milestones to maintain control over the process and limit costs, the company should advocate for a process that it believes is achievable and does not unduly jeopardize the likelihood of a successful case.

Conclusions

DIP financing is a core requirement for a successful outcome in most cases, and it is critically important for directors and officers to be advised by experienced professionals who can help navigate the complexities of DIP financing process. Companies should consider the following best practices when approaching a restructuring and potential bankruptcy filing involving DIP financing:

— Prepare for filing bankruptcy well in advance of a projected filing date to allow for the requisite work required to structure and size a DIP facility. The company will need to provide detailed forecasts of cash disbursements and receipts, capital expenditure and other budgeting, and an analysis of critical vendors and suppliers.

— Develop a granular understanding of the company's cash needs, dynamics around customers and cash receipts, specifics around key suppliers both in and outside of the U.S., and potential for disruptions caused by the process, normal seasonality, etc., and whether the proposed DIP loan is sufficient to accommodate these factors for the expected length of the case.

— Use the competitive process that is embedded in the Bankruptcy Code to the company's advantage to get the best loan terms available.

7.I AVOIDING A BANKRUPTCY FILING: CORPORATE DECISION-MAKING AND LIABILITY MANAGEMENT TRANSACTIONS

INVESTMENT BANK PERSPECTIVE

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Since the end of the financial crisis in mid-2009, six months after the Federal Reserve dropped the federal funds rate to near zero, non-investment grade companies have found it easier than ever to access the debt markets to raise cheap capital. The resulting "chase for yield" by investors led to increased competition in the leveraged loan and high-yield market, narrowing credit spreads and fueling the rise of covenant light ("cov-lite") loans and bond indentures that offered little to no financial covenants and considerably reduced protections for lenders and bondholders.

The twin dynamics of plentiful credit and loose credit protections naturally gave rise to a reduction in bankruptcy filings and an increase in what has become known as "liability management." Liability management generally refers to the practice of a company proactively addressing certain debts and obligations through a highly structured transaction negotiated out-of-court.

Certain distressed companies may seek to engage in liability management transactions to avoid filing for Chapter 11 bankruptcy. Chapter 11 filing is expensive (especially for equity since it is typically wiped out), can have long-term implications for a company's ability to raise capital in the credit markets and is typically value-destructive for all stakeholders. Other distressed companies that engage in liability management transactions typically do so well in advance of any potential restructuring catalyst to create breathing room to grow back into its capital structure and have the operational flexibility to reinvest in the business. Finally, non-distressed companies routinely engage in liability management transactions on an opportunistic basis as part of their corporate finance and capital allocation strategy.

To that end, companies may implement one or more liability management transactions to accomplish a variety of goals such as extending maturity runway, reducing debt service and deleveraging. Transaction options range from simple discounted debt repurchases and covenant amendments to more complex amend-and-extend ("A&E") transactions and various forms of debt exchange offers.

Structuring a liability management transaction

In certain instances, liability management transactions can represent a clear "win-win" solution for a company and its creditors and be accomplished relatively quickly with little negotiation. For example, a company and its debtholders could agree to loosen financial covenants in a company's debt documents in exchange for economics (e.g., amendment fees or an increase in interest rate).

However, in many other instances — where there is no clear or easy solution that benefits all parties — a liability management transaction can resemble a full-scale, out-of-court restructuring transaction where there are ultimately "winners" and "losers." In more complex capital structures, for example, one creditor constituency may be able to provide the company with the relief it needs in return for additional protections, economics, seniority and collateral at the expense of another creditor constituency.

The complicated give-and-take and intercreditor dynamics associated with such a transaction requires significant diligence, advance planning, structuring and strategy development by a company and its advisors. Each transaction is highly bespoke and the key to developing the optimal liability management transaction will depend on, among other things: (1) the company's capital structure objectives, (2) its creditors' objectives, strengths and weaknesses, and (3) the various "carrots and sticks" available to a company that make up its toolkit for negotiating with creditors.

Determining capital structure objectives

The first step in structuring a liability management is to determine the company's capital structure objectives and priorities. What does the company hope to achieve from a capital structure and financial flexibility perspective? If forced to make trade-offs, how does a company prioritize its different goals? Common capital structure objectives include extending debt maturities, obtaining relief from financial or other negative covenants, deleveraging through discount capture (i.e., exchanging debt that is trading below par for some combination of cash, equity and/or a lower quantum of debt to capture a portion of the debt's trading discount), augmenting liquidity through reductions in cash interest expenses and negotiating for the right to retain asset sale proceeds. In many situations, a company will have multiple capital structure objectives. Unsurprisingly, distressed companies commonly face an over-leveraged balance sheet, high cash interest expenses, a dwindling liquidity situation with little financial flexibility to address it and a sizeable debt maturity on the horizon — all at the same time.

While a company will often do its best to convince creditors that with just a little more flexibility it can maximize value for all stakeholders, creditors naturally tend to view the world through a zero-sum lens. It is thus highly unlikely that a company will be able to get everything it wants in a negotiation with creditors. Will an extension of debt maturities give the company adequate runway to execute its business plan and grow back into its capital structure? Or is the balance sheet over-leveraged such that there must be some amount of debt reduction for the company to have any hope of refinancing its debt at maturity? Having a clear view of priorities and what is most likely to provide a company with the ability to right-size its capital structure is critical to developing the right liability management plan.

Analyzing creditor profiles

Once the company determines what its primary capital structure objectives are, the next step is to analyze which of its creditor groups the company must negotiate with and carefully analyze such group's own objectives, motivations, strengths and weaknesses.

How strong is the creditor's position? Is it a senior secured creditor entitled to the first dollar of the company's value, or a junior unsecured creditor who may face substantial losses if the company were to file for bankruptcy? Is its debt trading at par or significantly below par, indicating that the market does not believe the creditor is likely to be paid in full? A creditor who is more at risk is more likely to engage with the company on a transaction that can materially improve the value of such creditor's position, limiting its losses in the event of a bankruptcy in the future and potentially even creating an immediate mark-to-market gain for its portfolio.

Other creditor dynamics, however, can complicate transactions as many creditors have different economic motivations and goals. "Loan-to-own" creditors seek to own the fulcrum security in a company's capital structure (i.e., the security that is most likely to receive the majority of a reorganized company's equity upon emergence from bankruptcy) for purposes of taking ownership of the company on the cheap in a Chapter 11 process and are thus less likely to engage with the company around a solution that extends runway for existing shareholders. "Net-short" creditors look to profit from a company's bankruptcy filing through outsized short positions through the purchase of credit default swap protection or other derivatives, while other creditors who have sold credit default swap protection could be incentivized to provide additional capital to the company to extend its runway and help it avoid a bankruptcy filing. Other creditors may have purchased multiple interests in a company's capital structure to hedge their positions, which can work for or against the company depending on the transaction being pursued. As there is no legal requirement to disclose these competing interests, the company must be aware of these potentialities when developing its liability management strategy.

Understanding the toolkit

After determining its capital structure goals and analyzing the applicable creditors' profiles, the company must then determine what value it can provide to creditors to convince them to engage in a transaction.

At its simplest, the goal of the company in any liability management transaction negotiation is to persuade its creditors that the value the company is offering is better than the creditors' alternative. The alternative can be what the creditors have today (namely the value of their debt claims in a status quo scenario absent a transaction) or what they will have in the future if they do not reach a deal with the company.

A simple framework when developing a company's transaction toolkit is to assess its various carrots and sticks. Carrots in this sense can be anything that improves a creditor's position compared to the status quo. Typical carrots include various forms of cash (e.g., partial paydown, increased interest rate or amortization and consent fees), improved debt securities (e.g., through additional collateral, tightened covenants and improving a creditor's seniority in the capital structure) and equity or equity-linked securities.

The provision of each of these carrots has its benefits and costs and will be specific to the company's situation. For example, creditors will likely want cash more than other types of consideration, especially when faced with potential losses on their investment in a distressed company. Providing cash, however, can put pressure on a company's liquidity and shorten its runway. Providing additional collateral or agreeing to tighten a debt document basket, on the other hand, may not have an immediate impact on a company's liquidity situation, but it can reduce a company's operational and financial flexibility in the future. While equity may be the cheapest and least-restrictive form of consideration, it dilutes existing shareholders and is often viewed as the least valuable currency by creditors in truly distressed situations where equity may have little to no value at the time of negotiation.

In contrast, sticks are anything a company can do that would make a creditor's position less attractive compared to the status quo. This can range from the prosaic (e.g., filing for bankruptcy or agreeing to provide available value, such as unencumbered collateral, to a different creditor constituency) to the aggressive, including:

— Covenant and lien stripping, whereby creditors exchanging into new debt agree to amend the existing debt documents to take away as many protective covenants and/or liens as possible from the non-participating creditors;

— Layering, whereby participating creditors exchange into new debt with a more senior position in the company's capital structure (e.g., from unsecured to secured or second lien to first lien debt), thereby layering the non-participating creditors with respect to the company's collateral or value; and

— Transfers of collateral, whereby the company utilizes permissive provisions in its debt documents to take assets out of a creditor's collateral package and transfer them into a new subsidiary where they can be used as collateral to raise new financing or pledged for the benefit of other creditors that participate in a transaction.

Importantly, the company's ability to utilize its potential carrots or sticks will be heavily dependent on the company's rights and obligations under its existing debt documents.

Debt documents

One of the primary ways a company can create leverage in negotiations with its creditors is to utilize its debt documents in creative ways to structure an attractive, value-enhancing liability management transaction. Undertaking an extensive review of a company's debt documents is therefore critical to developing and structuring any liability management transaction.

For example, debt and lien baskets in a company's debt documents may allow the company to raise new senior or structurally senior debt to augment liquidity or to use as exchange currency, while the creative use of asset sale, investment and restricted payment baskets can provide a pathway to transfer assets to unrestricted subsidiaries (i.e., subsidiaries not restricted by the company's debt documents), which can then serve as collateral for raising new debt or issuing new securities in an exchange, or provide the company with the ability to sell assets without having to use the proceeds to pay down debt. Even if such baskets are not ultimately used, identifying them can be highly valuable, as an offer to "close a loophole" or otherwise tighten certain covenants has served as a material carrot for creditors in several recent liability management transactions.

Primary types of liability management transactions

A&E transactions

An A&E transaction provides a company with a maturity extension in exchange for a package of consideration. In its purest form, this involves a company providing its creditors with, for example, an improved interest rate, enhanced covenants or some form of a paydown (usually at par) in return for a multi-year extension of a debt maturity.

The purpose of an A&E transaction is to provide management with the time necessary to execute its business plan and grow back into its capital structure. A&E transactions are frequently pursued when companies cannot cost-effectively refinance the maturity in question due to their distressed credit profile. Accordingly, the thesis for an A&E transaction typically relies on an operational turnaround story rather than a comprehensive capital structure solution.

Exchange offers

Exchange offers represent a broad range of transactions that typically involve the exchange of existing debt into newly created, like-kind, or common equity securities or a combination thereof.

In a debt-for-debt exchange transaction, a company's debt holders are typically asked to exchange their bonds for new bonds with lower face value, sometimes with an extended maturity and modified interest terms (e.g., a payment-in-kind ("PIK") coupon), and potentially equity securities and/or warrants. Although the new package often represents a discount to face value, it must exceed the market value of the bonds to be exchanged, thus providing a premium to creditors' existing trading positions and incentivizing them to participate in the exchange.

Uptier exchanges

The most common type of an uptier exchange is when a company offers to exchange unsecured bonds for a lower principal amount of secured bonds that are either pari passu with or subordinated to the company's existing secured debt (e.g., 1.5 lien or second lien). More generally, an uptier exchange can be any transaction in which a debtholder improves their position, either by gaining liens on collateral or improving their position with respect to such collateral (e.g., moving from second to first lien).

Importantly, uptier exchanges often require scarcity value to incentivize participation, since if everyone is allowed to uptier, then no one's position in the capital structure has improved relative to any other creditor (other than trade credit).

Drop-down transactions

A drop-down transaction generally refers to a structure in which a company transfers certain of its assets into an unrestricted subsidiary or designates a restricted subsidiary with valuable assets as unrestricted, and then uses the newly unencumbered assets as collateral for new financing or new debt securities in an exchange.

Superpriority exchange

In a "superpriority" exchange, a company negotiates with a majority of its lenders to amend its credit agreement to permit the issuance of superpriority loans, effectively subordinating the liens of non-participating creditors.

Superpriority exchanges typically involve the provision of new money by participating creditors, whereby the new money receives the superpriority liens at the top of the company's capital structure and is therefore fully covered by the value of the company's assets. Participating creditors will often have their existing debt moved up in the capital structure as well, layering non-participating creditors.

Conclusion

Liability management transactions have become a staple in a company's corporate finance toolkit over the last 15 years. Officers and directors should therefore seriously consider developing a comprehensive liability management playbook as a part of any management team's and board's contingency planning efforts, similar to the "break-the-glass" plans developed by public companies to address shareholder activism and hostile takeovers.

Even if a company is not currently in distress, prudent planning will better position it to move quickly should it find itself confronted with capital structure challenges in the future or when an opportunistic situation presents itself. Indeed, companies that wait until they are in distress to understand their capital structure issues and formulate a gameplan are frequently too late. Oftentimes, companies find themselves in positions where they could have benefited from a liability management transaction, but they do not have the requisite time to design and execute such a transaction, or realize that they have unwittingly given up certain of their tools in prior regular-way negotiations and/or allowed such tools to lapse via the degradation of credit statistics.

Developing a comprehensive playbook that can be executed opportunistically can take several months or more to fully develop, however, as such a process requires detailed legal, financial and capital structure analysis to develop bespoke transaction alternatives. It is therefore imperative for management teams and boards of directors to start planning early.

While liability management transactions can result in litigation from creditors that believe they are negatively impacted by them, e.g., J.Crew, Neiman Marcus, PetSmart, Serta Simmons, Boardriders and TriMark. However, the risk of litigation should not deter companies from exercising their contractual rights under their debt documents and pursuing value-accretive transactions that extend runway and facilitate deleveraging.

Case study: J.Crew's drop-down exchange transaction — July 2017

Background and capital structure

In the summer of 2016, J.Crew had approximately \$2.1 billion of debt, and its operating performance had fallen sharply over the last several years as retailers faced several new challenges, including the rise of "fast fashion" and the general shift away from brick-and-mortar stores to online retail channels. Weak top-line performance and margin pressures caused J.Crew's earnings before interest, taxes, depreciation and amortization ("EBITDA") to decline by 54% and total leverage to more than double since 2013.

J.Crew's $2.1 billion of debt consisted of a $1.5 billion senior secured term loan (the "Term Loan") due in 2021 borrowed by the operating company of J.Crew, where all of the assets were located ("OpCo"), and $560 million of unsecured PIK bonds (the "Bonds") issued by J.Crew's holding company ("HoldCo") due in 2019. The Company also had an undrawn $350 million asset-based revolver facility (the "ABL"). The Term Loan had liens on nearly all of the company's assets and thus had the right to receive the first $1.5 billion of value from those assets in a hypothetical bankruptcy. The Bonds were unsecured and were located at the HoldCo level, thereby making them junior not only to the Term Loan, but to every other potential creditor of OpCo, including the ABL, other potential lenders and even trade creditors.

In other words, while the Bonds were senior to J.Crew's equity sponsors, they would only be entitled to value after every other creditor had been paid in full. Given J.Crew's operating performance, the Bonds' upcoming maturity in 2019 and their precarious position in the capital structure, the Bonds were trading at around 32% of par. The market had effectively priced in both an expectation of bankruptcy and a very low recovery for the Bonds in such a scenario.

Determining capital structure objectives & analyzing creditor profiles

As J.Crew and its advisors examined its situation, a number of things became clear. While the company had an executable business plan that had a good chance of turning its fortunes around, it would not be accomplished by the time the Bonds matured in 2019. J.Crew had to convince the Bonds to extend their maturity past 2019, either through an A&E transaction or some form of debt exchange. On the one hand, the company and the Bonds ostensibly had the same goal: to avoid a bankruptcy filing that would wipe out junior stakeholders and destroy value for the business through disruption, damaged reputation and administrative expense. On the other hand, creditors are not typically interested in giving shareholders a "free option" to continue to spend money and attempt a turnaround that may not be successful, which could further diminish the value that would flow to the bondholders in the future. After all, it may be better to lock in a 32% recovery in 2019 rather than wait several more years and risk ultimately getting nothing.

Accordingly, J.Crew needed to identify value that it could provide to the bondholders to convince them to extend their maturities. J.Crew's value, however, was all located at the operating company level and subject to strict covenants under the company's Term Loan documents. Offering additional cash interest or paydowns to the Bonds was impermissible under the Term Loan credit agreement and would put further pressure on the company's liquidity in any event. Furthermore, there was no incentive for the Term Loan lenders to agree to let any value be transferred to the Bonds, especially in a transaction designed to simply extend runway for the benefit of shareholders. The Term Loan lenders were entitled to all of J.Crew's value in the event of a bankruptcy and their loan was trading at 85% of par — not so high that they would be amenable to share value for the benefit of other stakeholders, but not so low that they would be willing to give away value to "play for par" by avoiding a Chapter 11 filing in the near-term.

The Term Loan lenders were sitting in a position of seemingly maximum strength and would likely not be interested in letting a portion of their value flow to a junior creditor. In light of these constraints, how could the company generate value to offer as consideration to the Bonds when all the value was seemingly locked up by the Term Loan lenders?

Developing the toolkit

It was against this backdrop that J.Crew's advisors (Lazard and Weil, Gotshal & Manges LLP) analyzed the company's debt documents and developed a way to generate value through the creative use of unrestricted subsidiaries and investment baskets. In particular, they discovered that if J.Crew first invested assets into a foreign subsidiary, the company would be able to invest those same assets into an unrestricted subsidiary, which could then in turn use those assets as collateral for an exchange with the Bonds.

Realizing that its ability to form unrestricted subsidiaries was dependent on J.Crew meeting certain financial metrics that could be difficult to meet in the future, the company formed several unrestricted subsidiaries and put them on the shelf. Next, the company identified the assets most likely to be of interest to the Bonds and began the process of investing them into one of the newly-formed unrestricted subsidiaries. Specifically, given that J.Crew leased its stores, its primary fixed asset was its intellectual property. After obtaining a third-party valuation of its intellectual property assets and comparing that value to its investment capacity under the Term Loan credit agreement, J.Crew invested approximately 70% of its domestic trademarks into an unrestricted subsidiary ("IPCo"). The stage was now set to engage with its creditors.

The transaction

In January 2017, J.Crew made an exchange proposal to the two hedge funds that held the vast majority of the Bonds. At the same time, facing objections from the Term Loan lenders that the use of its investment baskets was not permitted under the Term Loan credit agreement, J.Crew pre-emptively launched a lawsuit seeking a declaratory judgment that blessed the multi-step investment of its assets into IPCo and began parallel discussions with both the bondholders and the Term Loan lenders in an effort to reach a consensual resolution.

After several months of structuring discussions and negotiations, J.Crew entered into an agreement with the Bonds that contemplated the following series of inter-related transactions:

- Exchange 100% of the Bonds for (1) $250 million of new bonds issued by IPCo, (2) $190 million in new preferred equity issued by the HoldCo and (3) 15% of J.Crew's common equity;
- Settle the litigation with the Term Loan lenders by (1) repurchasing 10% of the Term Loan ($150 million) at par in return for contributing the remaining amount of the J.Crew domestic trademarks to IPCo, funded by new debt at IPCo and a small amount of new Term Loans at OpCo, (2) increase the interest and amortization rate on the Term Loan, and (3) tighten the Term Loan credit agreement covenants.

J.Crew launched the exchange and amendment transactions in June 2017 and 30 days later had secured tenders from 99.85% of its Bonds and consents from 87.8% of its Term Loan lenders — well in excess of the 50.1% needed to consensually resolve the pending litigation. In the end, J.Crew was able to extend its runway by several years, deleverage its balance sheet by approximately $340 million, and captured approximately $130 million of trading discount.

7.II AVOIDING A BANKRUPTCY FILING: CORPORATE DECISION-MAKING AND LIABILITY MANAGEMENT TRANSACTIONS

LEGAL PERSPECTIVE

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When a corporation faces significant financial distress, its board of directors and management team must carefully consider all potential strategic alternatives that may provide relief, including whether the corporation should pursue an in-court or out-of-court process. In evaluating different alternatives in the zone of insolvency, directors and officers must be mindful of their expanded fiduciary obligations to all stakeholders. This chapter discusses corporate decision-making when a company becomes insolvent and the liability management transactions that may provide financial relief without a bankruptcy filing.

Corporate decision-making and potential challenges to transactions

Prior to evaluating strategic alternatives and liability management transactions, it is important that directors and officers be reminded of their fiduciary duties while a company is in the zone of insolvency.

Fiduciary duties

Directors and officers are fiduciaries of, and owe corresponding fiduciary duties to, their company and must make decisions consistent with their roles as such. Generally, this means that directors and officers must make decisions on behalf of the company that are in good faith and in a manner consistent with the best interest of the business.

Fiduciary duties are categorized as the duties of care and loyalty.

Duty of care

The duty of care is a fiduciary duty requiring directors and officers of a corporation to make decisions that pursue the corporation’s interests with reasonable diligence and prudence. Decisions made by disinterested directors and officers are generally protected by the “business judgment rule”; under this standard, courts will uphold actions so long as they are made in good faith with reasonable diligence and prudence.

Duty of loyalty

The duty of loyalty requires directors and officers to act in a manner that is in good faith, without personal economic conflict. They must put the interests of the corporation before any personal interests or those of another person or organization.

In normal circumstances (outside of the distressed context), these fiduciary duties flow directly to the corporation and its shareholders. However, when a corporation becomes insolvent, these fiduciary duties extend to creditors. As one court explained, "What changes upon insolvency is the constituency: the creditors are now the "risk bearers," so they now have the right, like stockholders, to bring a derivative action in the corporation's name against directors who "unduly risk" corporate assets." (*In re AWTR Liquidation, Inc.*, 548 B.R. 300, 325 [C.D. Cal. 2016.])

In distressed situations, directors and officers must balance aggressive liability management strategies, and make associated governance decisions, in light of fiduciary duties owed to all stakeholders. The failure to do so may expose such directors and officers to personal liability.

Other potential challenges to liability management transactions

In addition to potentially exposing directors and officers to suit based on alleged breaches of fiduciary duties, dissatisfied stakeholders may seek to challenge a liability management transaction on the grounds that it was not authorized by the subject debt documents, it constituted a fraudulent transfer or was otherwise improper.

Liability management transactions

A corporation working with its lenders may have a number of avenues to potentially avoid or delay a bankruptcy filing. The availability of such strategies, however, will depend on the precise terms of the corporation's debt documentation.

Covenant relief and consensual amendments to credit agreements

As a first step to any potential workout, management typically attempts to negotiate certain consensual amendments to credit agreements. Such amendments may include altering or stripping affirmative and negative covenants (and related events of default). In instances where a company has more than one lender, such amendments may require all or only certain lenders' consent.

Credit agreements often have a list of "sacred rights," which can be modified only with the consent of all lenders or all adversely affected lenders. These rights, and the concomitantly high consent-to-modify thresholds, protect the fundamental interests of minority lenders from being altered by the majority without minority lender consent. "Sacred rights" are typically limited to material covenants, such as maturity dates, scheduled payments, pro rata sharing provisions and collateral releases. Aside from modifications of "sacred rights," covenant amendments typically require only majority lender consent.

Accordingly, and as discussed below, if a matter is not expressly a "sacred right," companies may rely on the express terms (perhaps colloquially "loopholes" or "trapdoors") of credit documents, without material modification, to engage in liability management transactions.

Asset dropdowns

In asset-dropdown transactions, corporations use asset transfer flexibility in their existing credit documents to transfer ("dropdown") valuable assets and collateral (often valuable intellectual property or other intangible assets) out of the existing lender collateral package into new "unrestricted" subsidiaries. These unrestricted subsidiaries then typically raise additional debt using the newly transferred assets as collateral.

The following examples demonstrate how these transactions work.

J.Crew

J.Crew is a U.S. retailer that pledged, among other assets, its intellectual property to secure its $1.6 billion term loan facility. Given the challenges of operating in the distressed retail industry and an approaching maturity date for certain notes, the company urgently needed to find value or risked default.

J.Crew's debt documents contained common (and non-borrower friendly) negative covenants restricting investments in certain subsidiaries. These negative covenants included typical carve-outs: (i) a carve-out equal to the greater of $150 million or 4 percent of total assets for investments into non-guarantor *restricted* subsidiaries and (ii) a general carve-out equal to the greater of $100 million or 3.25 percent of total assets for investments into non-restricted subsidiaries. Relying on these two carve-outs, J.Crew transferred more than 70 percent of its interest in intellectual property, equaling to the cumulative $250 million permitted by these carve-outs, to a restricted subsidiary, J.Crew Cayman.

Relying on a third carve-out (permitting investments by restricted subsidiaries in unrestricted subsidiaries financed with proceeds received from an investment in such restricted subsidiary), J.Crew Cayman transferred the intellectual property it received to an unrestricted subsidiary, J.Crew Brand Holdings, LLC. Once the intellectual property interest was transferred to the unrestricted subsidiary, it was used as collateral for an exchange offer for the near-maturity notes. Litigation commenced by certain term loan lenders with respect to these transactions was ultimately resolved as noteholders purchased the majority of the senior debt.

PetSmart, Inc.

Using restricted payment and investment carve-outs, PetSmart was able to achieve a similar result by transferring 36.5 percent of its equity in its recently acquired subsidiary, Chewy.com, to its private equity sponsor and to an unrestricted subsidiary. It was also able to obtain releases of liens and a guarantee granted by Chewy with respect to the 63.5 percent equity that was not transferred.

In 2017, PetSmart acquired Chewy for $3 billion, funded through a combination of $1 billion in private equity contributions and $2 billion in financing. In 2018, relying on a generous investment carve-out under its existing debt documentation, PetSmart "invested" 16.5 percent of Chewy equity to a newly formed, unrestricted subsidiary. Separately, relying on a restricted payment basket, PetSmart transferred 20 percent of equity in Chewy as a dividend to its private equity sponsor. To make this restricted payment transfer, PetSmart's management determined that it could dividend, under an "available amount" basket, value in Chewy up to the original $1 billion investment received from the sponsor.

Following the restricted payment and investment transactions, Chewy was no longer a wholly owned subsidiary of PetSmart. Under common credit agreement provisions, the administrative agent was required to release any collateral or guarantees with respect to a subsidiary that was no longer wholly owned. When PetSmart demanded that the administrative agent release any liens on Chewy's assets and Chewy's guarantee under the existing debt documents, the agent countersued. Additionally, an ad hoc group of lenders sued PetSmart, challenging these transactions based on various covenant interpretations. Following various amendments to the credit documents, PetSmart obtained lender consent and the lawsuits settled, confirming Chewy's guarantee and lien release. Notably, while much of the equity in Chewy had been transferred away, the majority remained in a restricted subsidiary of PetSmart. However, because the agent had released its liens and Chewy was no longer a guarantor, the subject lenders' interests were structurally subordinate to Chewy's debts.

Cirque du Soleil

Relying on a similar strategy to J.Crew, Cirque transferred certain intellectual property, other than U.S. and Australian intellectual property, to a holding company controlled by its private equity sponsor. Facing the pandemic-induced shuttering of all in-person performances, Cirque required additional liquidity to offset a reduction in revenues. Cirque's credit documentation was structured more like a high-yield bond indenture than a typical credit agreement; it included a single restrictive payment covenant with respect to both dividends and investments and generous carve-outs. With this flexible document formulation, Cirque was able to transfer its intellectual property beyond the reach of its then-current creditors. It used the transferred intellectual property as collateral for a new loan of $50 million. Shortly after completing this transaction, Cirque restructured in-court in Canada and obtained recognition under Chapter 15 in the United States.

Current asset dropdown status

Using similar covenant exceptions and interpretations, numerous borrowers have successfully engaged in similar asset dropdown transactions. More recent credit agreements have attempted to preempt these types of transactions (absent consent) through various limitations, such as restrictions on material intellectual property transfers and investments by non-loan party restricted subsidiaries into restricted subsidiaries. Corporations should carefully analyze their debt documentation to determine whether an asset dropdown may be permitted to access otherwise encumbered assets.

Uptier exchanges

In uptier exchanges, borrowers typically offer certain existing senior creditors the opportunity to exchange a portion of their debt for new, structurally senior debt. In an uptier transaction, the borrower amends its existing loan documents to permit the incurrence of superpriority debt and to remove any provisions prohibiting or limiting the subordination of existing loans. Additionally, the relevant parties typically enter into a new intercreditor agreement that governs the relative priorities of the post-transaction tranches of debt. With the exception of "sacred rights," discussed previously, the corporation typically only needs the consent of "required lenders" (usually a majority) for such amendments.

The following recent examples demonstrate how uptier transactions work and identify potential pitfalls.

TriMark

In August 2017, through a leveraged buyout, private equity firms acquired a majority stake in TMK Hawk Parent, Corp. (DBA "TriMark"), a food-service equipment distributor. Roughly two-thirds of the purchase price was financed through an $820 million syndicated loan. In early 2020, because of pandemic-related restrictions on indoor dining, the company faced significant financial distress.

In an effort to resolve financial constraints, lenders holding a majority of the syndicated debt collaborated with TriMark and its sponsors to execute an uptier exchange comprised of three primary components. First, TriMark entered into a Super Senior Credit Agreement where the company issued new First-Out Super Senior Debt (Tranche A Loans) to the collaborating lenders. TriMark did not offer to issue this new debt to the remaining lenders in the syndicate. This is a hallmark of an uptier exchange. Second, TriMark issued new Second-Out Super Senior Debt (Tranche B Loans) to the collaborating lenders in a dollar-for-dollar exchange of the debt they originally held in the original loan. Third, TriMark and the participating lenders amended the original credit agreement, stripping covenants that might have prohibited the first two transactions and adding provisions intended to impede the remaining lenders from successfully filing suit against the borrower and the collaborating lenders.

The non-collaborating lenders sued, and the collaborating lenders and TriMark moved to dismiss. The New York Supreme Court issued an opinion, *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp.*, No. 565123/2020 (N.Y. Sup. Ct. Aug. 16, 2021), granting in part and denying in part the defendants' motions to dismiss. In denying in part the motions to dismiss, the Court found that the original credit agreement could be reasonably read to require the non-collaborating lenders' consent for the challenged amendments.

On January 7, 2022, TriMark issued a press release announcing that it reached a consensual resolution of the dispute with the non-collaborating lenders. Under the settlement, TriMark will exchange all outstanding original debt for Tranche B Loans, and the Tranche A Loans will remain senior to the Tranche B Loans.

Serta Simmons Bedding, LLC

In a June 8, 2020 press release, Serta announced an agreement with a majority of its first and second lien term lenders to repurchase hundreds of millions of dollars of term loans in exchange for new superpriority loans (senior to the then-existing first and second lien debt), effected through, among other transactions, various amendments to the existing loan documents. Non-participating lenders immediately challenged the transaction in New York State Court and requested a preliminary injunction to block the transaction. They argued, in part, that any change in the pro rata distribution provisions of the subject credit agreement required approval of all affected lenders.

The State Court denied the motion for a preliminary injunction, holding that the credit agreement "seem[ed] to permit[] the debt-to-debt exchange on a non-*pro rata* basis as part of an open market transaction." (*North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, No. 652243/2020 [N.Y. Sup. Ct. June 20, 2020.]) The Court concluded that "[s]ince the amendments do not affect plaintiff[s'] so-called 'sacred rights'[] under the Credit Agreement, plaintiffs' consent does not appear to be required."

Other lenders challenged the transaction in the U.S. District Court for the Southern District of New York. The District Court dismissed the case on jurisdictional grounds and did not address the substance of the transaction.

Chesapeake Energy Corp.

In December 2019, Chesapeake Energy engaged in an uptier exchange of $3.2 billion in then-existing unsecured notes for $2.2 billion in second lien notes, reducing the company's pro forma debt obligations and extending maturity dates. Additional second lien notes were issued pursuant to a private offering. Unlike in the transactions discussed previously, Chesapeake Energy and certain affiliates filed for Chapter 11 bankruptcy shortly after closing on the uptier transaction. During the Chapter 11 cases, the official committee of unsecured creditors sought standing to challenge the uptier transaction, alleging that only certain preferred creditors "could reap the benefits," as they had exchanged unsecured debt for secured debt. Specifically, the committee sought standing to challenge the liens granted pursuant to the uptier transaction as both constructively and actually fraudulent transfers.

In a brief oral ruling denying the committee's standing motion and confirming Chesapeake Energy's Chapter 11 plan, the Bankruptcy Court found that settlements embodied in the plan, including those that settled claims related to the uptier exchange, were appropriate and comprised a "prudent exercise of business judgment" by Chesapeake Energy's management. The plan and associated settlements went effective shortly thereafter.

Recent uptier exchange status

Recent uptier exchanges provide a clear model for reducing pro forma liabilities in exchange for senior debt. Although such exchanges may be the subject of litigation, borrowers have been successful in defending against such suits and closing on uptier transactions.

Conclusion

Directors and officers of distressed companies have a number of tools available to them short of a bankruptcy filing to manage liability. Good faith, along with well-informed and prudent tactical decisions, can both satisfy fiduciary obligations and lead to improved financial standing.

Consensual covenant relief and amendments are often appropriate first steps in any workout. Asset dropdowns and uptier exchanges, where permissible or possible under existing debt documentation, are valuable alternatives as well. With appropriate advisors, management of a distressed company should analyze its credit agreements and other debt instruments to determine whether any of these, or any other liability management transactions, may be possible.

8.I DISTRESSED COMPANY COMMUNICATIONS: MAINTAINING CREDIBILITY WITH KEY CONSTITUENCIES

LEGAL PERSPECTIVE

Cravath, Swaine & Moore LLP

George E. Zobitz, *Partner*

Paul H. Zumbro, *Partner*[1]

Either in or out-of-court, a successful restructuring requires the support of creditors and other key constituencies. Therefore, when addressing financial distress, directors and officers should be mindful of more than just legally required disclosures. This chapter provides an overview of the strategic benefits that transparency can bring, as well as certain pitfalls to avoid.

Be appropriately transparent with creditors

Usually, the most important constituency that directors and officers must deal with in a distressed situation is the company's creditors. Negotiations with creditors may result in solutions such as longer payment terms, covenant relief or other amendments to debt agreements that will allow the company to meet its obligations. Creditors are more likely to agree to these concessions when they believe the company is transparent about its financial situation and the challenges it is facing that have led to the distress. Transparency and consistency in communication with creditors can, in turn, give creditors confidence in management and their turnaround plan — a key driver of achieving a successful workout or restructuring out-of-court. Bankruptcy can be a costly, time-consuming, uncertain and contentious process; if it can be avoided, it is usually in the best interests of both the company and its creditors to do so.

As a condition to granting a short-term forbearance or any long-term concessions, creditors will generally require more detailed and frequent reporting from the company than the company is accustomed to, particularly in the beginning stages of the workout. This may include monthly or weekly financial reports, management calls and reports from financial or other restructuring advisors to the company covering metrics of interest to the lenders. Lenders will typically want to monitor the company's financial situation closely during the entire period of financial distress — and for some period thereafter.

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[1] The authors thank Nicholas A. Dorsey, Capital Markets Partner, and John A. Marcin, Corporate Associate, for their contributions to this chapter.

Be mindful of creditor group motivations

Not all creditors are motivated to achieve a successful workout or restructuring that allows the company to continue as a stand-alone going concern. Some may want to take the opportunity to acquire equity control of the company, some may be looking for a short-term bump in debt trading prices that allows them to trade out of the name at a profit and some may be looking to trip a "credit event" to benefit from a position in credit default swaps or other derivative financial instruments. The potential motivations are practically endless, and undisclosed positions can impact motivations in ways that are not transparent to the company and its management.

Due to the varying interests and motivations of different groups of creditors, a company in distress must be careful not to divulge information that could be used to benefit a creditor group at the expense of the company. For example, while traditional lenders such as banks are typically more interested in maximizing recoveries in a going concern workout, hedge funds and activist debtholders may be more likely to pursue short-term strategies, backed by the threat of triggering or calling defaults and forcing a company into bankruptcy, as well as various "loan-to-own" strategies.

In addition, a company should not disclose projections to financial creditors that overstate the degree of the company's distress in an attempt to extract concessions from financial creditors, while at the same time disclosing relatively optimistic projections to its suppliers and trade creditors to keep them comfortable with continuing to do business with the company. The company should take care that its internal planning projections are consistent with what it is disclosing to its creditors. To the greatest extent possible, when making disclosures — either publicly or in private negotiations — those disclosures should be consistent in order for a company to maintain its credibility with all parties. This is an area where a company in distress can benefit greatly from a competent restructuring financial advisor and legal counsel to maintain a single source of consistent financial and legal disclosures throughout the process.

A delicate balance must be struck in determining *what* should be disclosed *to whom* and *when* in order to negotiate effectively both with creditors whose interests are aligned with the company's as well as those whose interests may not be. Of course, no creditor group is likely to have interests that completely align with management, so directors and officers must be thoughtful about the timing and content of disclosures to navigate the period of distress successfully.

Disclosure of raw information without context may do more harm than good. On the other hand, lenders to distressed companies generally hate surprises and feeling that they are being kept in the dark, so sometimes information must be disclosed promptly to maintain trust and credibility. There is no one-size-fits-all solution for every situation. Experienced restructuring counsel and financial advisors can assist in navigating these situations and help guide the best course of action considering a company's particular creditor constituencies and circumstances.

Make factual and reasonable projections

Financial distress imposes enormous pressure on directors and officers, and management may be tempted to "project" its way out of distress by telling the lenders what they want to hear with unduly optimistic projections. This strategy rarely (if ever) works. Aside from setting themselves up to disappoint and lose credibility with the lenders, directors and officers may face liability for making overly optimistic or simply untrue statements regarding the company's prospects and ability to satisfy its obligations. The better approach is to present reasonable base, upside and downside projections so that management and the company can maintain the trust of its lenders over time by delivering on what they promise.

The board will need to take a more active role during a period of distress, including approving management projections and material communications with creditors. Experienced legal counsel and financial advisors are indispensable to ensure that these communications are appropriately vetted and contain both the appropriate level of detail and appropriate disclaimers.

Consider a chief restructuring officer or special committee

While this chapter emphasizes the importance of maintaining creditor relationships through appropriately transparent communications, sometimes those relationships have already been significantly damaged and need repair. In such cases, a company may benefit from appointing a chief restructuring officer ("CRO") and/or a special committee for restructuring matters. Those appointed should be independent and free from conflicts to instill confidence in creditors.

Even where relationships with creditors are relatively good, a company can still benefit from a CRO or special committee, as there are many experienced professionals in this area who have encountered similar situations and have often negotiated with the same or similar creditors to reach a successful result. This frees management to focus on running the business, while the CRO deals with restructuring the balance sheet.

If a company decides to appoint a CRO or special committee, creditors will want input on the persons appointed. They may insist on approval rights as a condition to a forbearance agreement or other arrangement. Whether the creditors have the right to approve or not, seeking creditor input may pay dividends as settling on a mutually agreeable CRO or special committee will start negotiations on a positive note. The right CRO can provide much needed credibility that will redound to the benefit of the company and all its stakeholders.

Transparency may be inevitable

If an out-of-court restructuring cannot be accomplished, a bankruptcy filing may be necessary. A fundamental principle of bankruptcy is the public and transparent nature of the process. All filings in a bankruptcy case are public, with only the narrowest of exceptions, and companies in bankruptcy are required to file detailed financial reports every month, which will be scrutinized by creditors, the Office of the United States Trustee (a division of the Department of Justice responsible for the oversight of the bankruptcy process), the bankruptcy court and the public.

In addition, any transaction that is "other than in the ordinary course of business" is subject to the approval of the bankruptcy court, after notice to all creditors and interested parties of the details of the transaction, which must be filed publicly on the court's docket. Courts are extremely reluctant to grant requests to redact information from such filings. Once the bankruptcy petition is filed, directors and officers should understand that the company will be operating in a "fishbowl" environment.

Directors and officers must also be mindful of any communications in open court, particularly by its restructuring counsel. All court hearings are public and closely followed by the financial and restructuring press, who will often report the proceedings on a real-time feed or live blog. While it is not possible to fully script this messaging as counsel responds in real time to questions from the court and other developments during a court hearing, management should coordinate with counsel in advance of major hearings to make sure the board and management are comfortable with the overall messaging of counsel's expected presentations to the court.

Be appropriately transparent with vendors, employees and customers

In addition to creditors, a company's vendors, employees and customers are other critical constituencies to whom a distressed company's communications must be carefully considered. While it is important to resolve a distressed company's balance sheet, the company's operations must also be maintained and improved where necessary to ensure long-term viability and success.

Upon learning of a company's distressed situation, each of these constituencies may become hesitant to continue dealing with the company. Vendors may insist on shorter payment terms, less flexible payment options or even cash-on-delivery. Employees may fear layoffs, leading to an employee exodus and damaged employee morale and productivity. Customers may be hesitant to make purchases if they are unsure that the company will deliver or maintain its products.

Directors and officers of a distressed company should be proactive and get in front of any reports of distress by communicating clearly to these constituencies and clarifying the company's liquidity position and its plan to address the issues it faces. Again, a delicate balance must be struck. A company should disclose enough detail to convincingly reassure these constituencies without jeopardizing its negotiating position with financial creditors. However, as discussed, a company must be careful to avoid providing unduly optimistic statements and projections to any constituency.

There is also a sequencing aspect, as reaching agreement with the company's main financial creditors may provide significant comfort to its vendors and employees.

Required disclosures

Importantly, a bankruptcy filing does not relieve a public company of its reporting obligations with the Securities and Exchange Commission ("SEC") unless and until it has deregistered. However, neither the New York Stock Exchange nor the Nasdaq provide for automatic delisting upon a bankruptcy filing. Therefore, in addition to the categories of communications already described, there are several required disclosures that directors and officers of a distressed company should keep in mind.

Going concern disclosures

The rules of financial reporting generally require a discussion by management of a company's financial situation. In the past, accounting rules required auditors to report when a company may be unable to continue to meet its financial obligations; however, there are now rules requiring management to assess whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the company's ability to continue as a going concern within one year after its financial statements are issued. Sears was one of the first high-profile companies that made such a company management "going concern" disclosure in its annual report filed in March 2017; Sears filed for Chapter 11 protection 18 months later.

Regulation FD and cleansing disclosures

While communicating with creditors is necessary for companies facing covenant defaults or other financial distress, public company management must be mindful that, pursuant to SEC Regulation FD, any material non-public information ("MNPI") shared with outside entities — unless subject to strict confidentiality obligations — will need to be furnished concurrently to the public via a broadly disseminated press release or a filing with the SEC.

One typical method to avoid immediate disclosure of such information to the public is to have creditors agree to receive information under a non-disclosure agreement. However, creditors are often reluctant to become restricted from trading due to knowledge of MNPI, and typically require an outside date by which any MNPI must be disclosed publicly, hence "cleansing" the creditor of any MNPI-based trading restrictions. These cleansing disclosures are unlike periodic disclosures management is used to making, and typically involve the disclosure of term sheets or presentations relating to restructuring proposals and the like. This is another area where experienced counsel and financial advisors can help guide the company.

Distressed company disclosures

Companies required to report with the SEC must make appropriate and timely disclosures in their periodic (quarterly and annual) reports. In addition, disclosure of material interim developments may be required under the securities laws or stock exchange rules or otherwise be appropriate under principles of good corporate governance. Matters that should be disclosed may include liquidity issues, inability to make interest payments on bonds, pending lawsuits that could have a material adverse financial impact on the company and the need to engage in restructuring discussions. While these are often initially couched in terms of "evaluation of strategic alternatives" or similar language, once it becomes clear that a bankruptcy filing may be required, the company should disclose that specifically. The specific disclosures will depend on the company's specific circumstances but at the relevant time appropriate disclosure must be made or the company may face claims under the securities laws in addition to whatever other problems have led to its financial distress. These securities law claims can complicate the Chapter 11 plan process.

Non-public companies facing financial distress generally have greater flexibility in terms of the timing and nature of disclosures but, for the reasons discussed in this chapter, they should also keep their creditors and other constituencies reasonably informed of important developments.

A cautionary note on distress signaling

Certain actions of a distressed company's management may inadvertently signal to creditors — and the market as a whole — that the company's situation is deteriorating toward bankruptcy. One key signal is the filing of a Form 8-K with the SEC announcing the payout of large off-cycle bonuses to management. The market has come to view these types of 8-K filings as a clear signal of a pending Chapter 11 filing.

Companies should discuss with legal counsel any contemplated actions that may inadvertently (or prematurely) signal distress to the market and unnecessarily damage relations with creditors, customers and employees at a critical stage.

The bottom line is that distressed company disclosures — like all company disclosures — should be timely and accurate. The increased scrutiny that comes with financial distress means that more attention and thought needs to go into the communications plans and protocols of distressed companies. The board needs to more actively manage the process with the assistance of experienced outside legal and financial advisors and, where appropriate, communications specialists.

8.II DISTRESSED COMPANY COMMUNICATIONS: MAINTAINING CREDIBILITY WITH KEY CONSTITUENCIES

STRATEGIC COMMUNICATIONS ADVISOR PERSPECTIVE

FTI Consulting

Shannon Stucky Pritchett, *Senior Managing Director, Global Co-Head of People & Transformation*

Rachel Chesley, *Senior Managing Director*

A restructuring process necessitates clear and direct engagement with stakeholders. An organization needs to tell key audiences what is happening, how it impacts them (or doesn't) and what they can expect moving forward. Early impressions of leadership will shape perceptions throughout the process, and trust — once lost — is very difficult to regain.

One of the most common mistakes organizations make when preparing a restructuring communications strategy is to view it as a singular event rather than a process. At every stage, there are legal requirements and milestones, but there are also critical moments to provide context and — to some extent — reassurance to employees, customers, vendors, investors, regulators and other audiences. Failing to communicate effectively and consistently can erode stakeholder confidence and jeopardize a successful outcome.

The goals of communications in a restructuring are to:

— Preserve business continuity, including maintaining customer relationships, retaining employees, progressing in-flight proposals and protecting other key relationships that enable the business to operate as usual;

— Equip employees with materials and skills to communicate effectively with stakeholders;

— Protect management credibility;

— Achieve balanced, accurate media coverage.

Below we provide a high-level overview of strategic communications considerations at each stage of the restructuring process.

Contingency planning / Ongoing distressed company communications

There will inevitably be certain details an organization is not able to share prior to an in- or out-of-court restructuring event. However, this does not mean leadership can ignore the signals transmitted into the marketplace either. In fact, the uncertainty of the situation makes it more important to remain visible and not shirk on communications efforts, conveying a consistent message and ensuring questions are answered only by those who fully understand the various contingencies that may materialize.

Below are a few key opportunities to take control of the restructuring narrative before it occurs:

— **Announcements and milestones**: Earnings calls, forbearance agreements, ratings agency decisions and formal announcements of a review of strategic alternatives and/or sale process all establish precedent for filing-related messaging. Standing employee "town halls", industry events, customer meetings and other events raise expectations for more comprehensive updates. Getting the messaging right at each of these moments is important, as well as being prepared for the inevitable questions that follow, to ensure the organization isn't making promises it cannot keep.

— **Cash management & other stakeholder tensions**: During this period, many distressed organizations move toward more purposeful liquidity management, which may include stretching vendors, delaying operational investments or other actions that are visible to stakeholders. To maintain continuity in the supply chain, prevent changes in terms and preserve vendor and customer confidence, it is important to issue formal guidance about how questions should be answered or forwarded to senior leaders, and to provide proper training for anyone who is answering questions related to the organization's financial health or the status of specific payments. Particularly with vendors, it is important that escalations move to a small group of authorized Accounts Payable / Procurement employees who have the knowledge and composure to address difficult situations while maintaining credibility for the organization.

— **Market rumors and speculation**: Whether sparked by a competitor trying to gain an advantage, a counterparty looking to accelerate negotiations, an enterprising reporter pursuing a story, or a vendor seeking to draw attention to a payment owed, bankruptcy rumors can escalate at any time. It is critical to have a plan in place to ensure rumors are quickly elevated to those in a position to craft an appropriate response. The response team should have a clear framework for evaluating speculation and inquiries, be lean enough to make decisions quickly and have the authority to issue a statement, if warranted. The best "leak strategies" have statements and other stakeholder materials ready to go, if needed.

Filing preparation

Whether executing a sale, aligning the capital structure with current business prospects or addressing operational challenges (like lease obligations or burdensome litigation liabilities), the filing itself should not be the entire story — rather, it is a *tool* to put the organization back on a path toward long-term success. The filing should be positioned as a bridge between all the efforts taken to date and how the organization will ultimately emerge as a financially stronger organization, well positioned for the future.

Of course, even the best messaging can only succeed if it is properly tailored and shared with all key stakeholders in a timely manner. Stakeholders will not hear what an organization is trying to achieve until their immediate questions have been answered. For this reason, a successful restructuring communications strategy and rollout will anticipate and address the unique needs of each stakeholder group within the first set of communications, which are generally distributed minutes after the organization has filed to ensure all stakeholders first hear the news from the company.

Among the key stakeholders to consider are:

— **Employees**: Including impacts (or lack thereof) to employment, responsibilities, compensation, reporting and benefits; this may require versioning for certain groups that may be impacted differently because of the roles they hold, where they are based or how they are compensated (e.g., stock options or pensions);

- **Customers**: Including real or perceived impacts to special programs, discounts, warranties and product availability;
- **Vendors**: Including the requirements of the process and how outstanding liabilities may be handled differently depending on whether the vendor is deemed critical;
- **Landlords**: Including those whose leases may be rejected through the bankruptcy process;
- **Regulators, political leaders and other opinion elites**: Including company-specific issues ranging from job preservation to environmental health and safety concerns.

As a definitive announcement looms closer, additional leads will likely be brought "under the tent" to help identify which members of each stakeholder group will require a personal conversation, assign communications responsibility for each of these touchpoints and ensure that other contacts are put into an effective holding pattern via emails, website posts and other communications intended for a broader audience. These leads will need time to process the imminent announcement and be trained on the process, implications and messages for their respective audiences — but their expertise is essential to putting the organization in the best possible position at the start of the process.

Filing

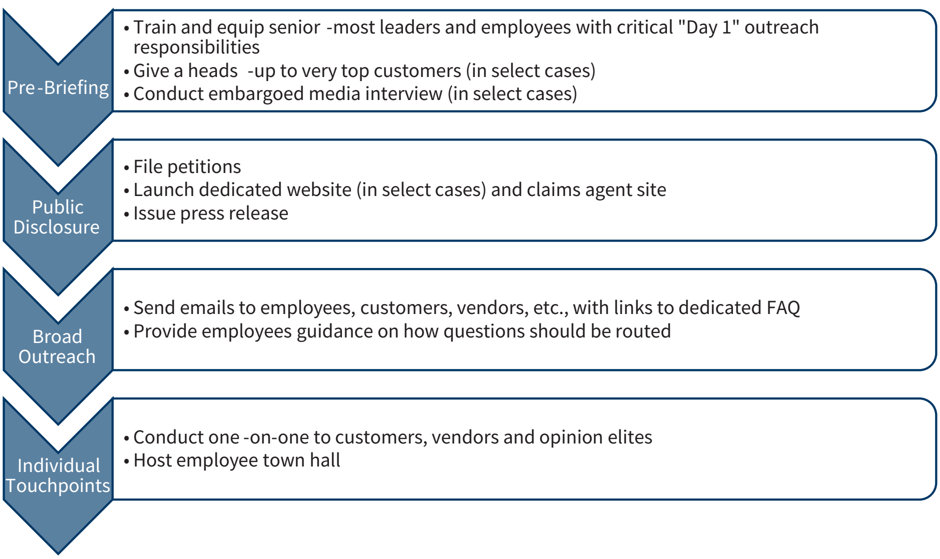
If the preparation strategy outlined below is followed, the organization should be well-prepared for the announcement day. Once the petitions have been filed and the press release has been issued, critical information should reach all stakeholders in real-time. A typical cascade is as follows:

Once the initial sequence of communications is complete, attention shifts to focus on:

- Any immediate threats to business continuity (e.g., if vendors are threatening to stop shipments or workers are threatening to strike);
- How information is being understood — and if additional clarifications are needed;
- Questions that are surfacing, particularly those the organization may not have anticipated in prepared Q&A documents.

Effective communications planning should include communications touchpoints, including microsites,

EXHIBIT 10. Preparation Strategy



Source: FTI Consulting, Inc.

hotlines and other feedback mechanisms, and it is the responsibility of the communications team to ensure that inquiries are promptly acknowledged and addressed. Building and maintaining trust requires a two-way dialogue.

Most notable is the role that communicators play in engaging with the media. Restructuring has a dedicated "beat" of reporters who understand the process and are generally fair and balanced. Nevertheless, engaging directly and monitoring coverage for needed corrections is important, particularly in large, complex or high-profile cases where reporters outside of the coverage landscape will be taking on the story.

Another primarily reactive workstream is investor communications. In most restructurings, shareholders will lose the full value of their equity investments as part of a Chapter 11 bankruptcy process. There is little — if anything — the company will be able to do to make this outcome more palatable, but each inquiry should be acknowledged by communicators who can demonstrate empathy without deviating from approved messaging. That approved messaging is typically simple and primarily directs investors to their own legal or financial advisors for any questions, as the company is unable to provide advice on investments.

A note on the word "bankruptcy": Where possible, the organization should be clear in its use of terminology and limit jargon, but it is also necessary to define key terms that stakeholders may need to understand (e.g., "pre- and post-petition," "363 auction," and "DIP loan"). One challenge is the word "bankruptcy" itself, which has prevailing negative connotations, especially for companies that operate in international markets where "bankruptcy" often means liquidation. Rather than shy away from the term, we counsel clients to define it and educate stakeholders. After all, media outlets will likely to refer to "Chapter 11 bankruptcy" in their coverage and the "U.S. Bankruptcy Court" venue may give it away. It's better to define the term and control that narrative rather than to let it be defined for you.

First day motions through confirmation

Outside of a select group of leaders directly supporting the process, organizations are often surprised at how quickly operations return to normal after the first announcement has passed. This milestone can be underscored by an email confirming that First Day Motions have been approved, emphasizing a quick win on the organization's promise to protect stakeholder interests.

While effective communication with key stakeholders helps organizations return to normal operations more quickly, that doesn't mean anxieties disappear entirely. The ongoing cadence of hearings, objections, filings and legal notices mailed to groups including vendors, customers, investors and current and former employees, can feed the rumor mill and make new waves of media coverage.

Questions may include:

— Why am I receiving mailings from a claims agent? Does this mean the company owes me money?

— Why was I not included in key employee retention or incentive program? How were amounts determined?

— How can I be included in the critical vendor motion?

— How does this sale process work? Is it bad that we are holding an auction for our company?

— Do I need to file a proof of claim form?

— Why should I vote for this plan? How do I vote? Am I bound by the vote?

— What is a cure notice? Why is my cure amount lower than my claim?

As a rule, the best defense is a strong offense. Rather than waiting for questions, use hearings and filings to demonstrate momentum toward the stated objectives for the case, proactively work to demystify the concept, process and terms and update materials for those audiences that engage directly with external stakeholders. Create a reputation for transparency that maintains (or rebuilds) trust.

Emergence

As emergence approaches (sometimes culminating in a successful sale process), those closest to the case start to see the light at the end of a long tunnel and breathe a sigh of relief. For others, the completion of the restructuring transaction(s) simply raises a new series of questions: How will the organization capture the new opportunities promised at the time of filing? How will employees benefit? Will new owners — potentially including lenders who have taken a new or larger ownership stake — take the organization in a new direction? Will austerity measures continue? Will day-to-day management change? The list goes on and on.

A newly restructured organization has a unique opportunity to reposition its value proposition for stakeholders, and there is only one chance to get it right. Whether it's a formal rebranding, website refresh, celebratory event, roadshow, or some other strategy, employees will take their cues from the first communications, and their confidence (or lack thereof) will flow into other critical stakeholder relationships. Similarly to the filing, it is important that teams view emergence as a step toward larger goals and take energy from the new opportunities this milestone presents. The odds are that more change is coming — and the aim is to position that favorably.

A final word

While there are certainly best practices to be leveraged, there is no singular template for restructuring communications. Situations — and thus, messaging — are nuanced, and an organization must always be thinking ahead to anticipate and mitigate potential concerns at each step in the process. Experienced strategic communications advisors understand that a restructuring is a journey and can help see around the next curve to protect continuity and value through the process and beyond.

9 THE NEED FOR SPEED: ACCELERATING THE CHAPTER 11 PROCESS

LEGAL PERSPECTIVE

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At some point in his or her career, nearly every executive and board member has served on a management team or board of a company facing the prospect of too much leverage, a pending financial default or major litigation exposure. When your lenders are no longer willing to amend and extend and refinancing is not an option, all companies begin to contemplate the possibility of a Chapter 11 bankruptcy filing.

Chapter 11 can be a very effective tool to implement a company's turnaround strategy or to reorganize an over-leveraged balance sheet, all while maximizing value for the company and its stakeholders. However, without effective planning and close management, the benefits available under the Bankruptcy Code may be diluted by the cost of remaining in bankruptcy longer than necessary. On top of ordinary course operating expenses, a company in bankruptcy must also pay the fees and costs of its own advisors and usually the advisors retained by lenders and official or unofficial creditors' committees. This is in addition to quarterly fees that must be paid to the U.S. Trustee. Further, while this risk can be mitigated with proper messaging, prolonged stays in Chapter 11 can cause reputational harm with both new and existing vendors and customers. In light of the aforementioned points, it should not be surprising that an expedient exit from Chapter 11 can preserve substantial value that a company's management and advisors must factor into their bankruptcy planning and strategy.

No two distressed companies have identical issues that can be resolved through a pre-set rubric. The ultimate approach implemented will depend in large part on the nature of the company's business, the complexity of its capital structure and the level of cooperation among its key stakeholders. Depending on these considerations, a company in financial distress may be able to "right the ship" without a bankruptcy filing at all and rather complete its restructuring "out-of-court." However, in many instances, a company will elect to pursue a Chapter 11 filing in order to avail itself of the tools available under the Bankruptcy Code. In general, Chapter 11 filings can be categorized as "pre-packaged," "pre-negotiated" or "free-fall" cases. Each option can bring significantly divergent durations in bankruptcy, while at the same time carrying its own unique set of other benefits and drawbacks. This chapter briefly explores the principal considerations that any corporate decision-maker should consider in evaluating these available alternatives, with a particular focus on in-court options that provide for maximal speed and efficiency.

Overview: multiple options to implement a comprehensive restructuring

Out-of-court

As an initial matter, a company in financial distress will typically look first to an out-of-court restructuring transaction, using only those tools available at contract and under applicable non-bankruptcy law. The form of an out-of-court transaction will usually be dictated by the company's particular concerns. For example, impending funded debt maturities may, depending on the company's credit ratings and financial health, be addressed through a refinancing or maturity extension. An isolated liquidity shortfall, on the other hand, can potentially be addressed through a new money debt incurrence or equity raise, depending on the company's credit profile and prospective investor appetite. Where a company's financial issues are more complex, it may be necessary or advisable to pursue a more comprehensive solution, potentially incorporating a distressed exchange (i.e., the consensual exchange of outstanding securities for new securities, often with a lower face amount or different priority).

While each of these transactions can be consummated expediently, it may be necessary for the company to procure the affirmative consent of certain existing lenders. Obtaining these consents may be difficult, especially where the company is not in a position to offer adequate economic incentives to participants. If the amount of indebtedness held by non-participants (i.e., "holdouts") is sizable enough, a consensual transaction may not be feasible. In that case, the company may turn to other alternatives, likely through the U.S. Bankruptcy Courts, which offer a powerful method to bind holdout stakeholders through use of the Bankruptcy Code's majority voting mechanic and "cram down" provisions.

In-court

U.S. in-court processes have historically taken one of three forms. The most expedient from start to finish is the filing of pre-packaged Chapter 11 cases, which can often take approximately 30-60 days from filing to exit, although such cases can sometimes be implemented significantly more quickly. In short, pre-packaged cases entail the negotiation of a plan and the solicitation of votes thereon, each on an out-of-court basis and prior to the bankruptcy filing. After a sufficient majority of affirmative creditor votes are received, the debtor files its plan, together with its Chapter 11 petition, seeking expedited approval by the bankruptcy court and a swift exit from Chapter 11.

The second option, pre-negotiated Chapter 11 cases, entail the out-of-court negotiation of a Chapter 11 plan with key creditor constituencies, while reserving the solicitation process for the post-filing period. Only after solicitation concludes is the debtor able to seek confirmation of its plan by the bankruptcy court. In a pre-negotiated process, debtors may be able to achieve confirmation in as few as 60 days, but often 120-150 days, post filing, with the delay relative to a pre-packaged process attributable to various notice periods mandated by the Bankruptcy Code and, potentially, dissident creditor interference.

The third option, a traditional (or "free-fall") Chapter 11, entails filing for Chapter 11 protection without the benefit of significant pre-petition stakeholder support. Due to the need to negotiate a workable restructuring transaction in-court, the involvement of numerous parties in interest and various timelines imposed by the bankruptcy court, free-fall Chapter 11 cases often take much longer than either a pre-packaged or pre-negotiated path. As a result, debtors pursuing a free-fall filing often bear increased costs and heightened execution risk.

Pre-packaged Chapter 11 cases

Mechanics

Pre-packaged Chapter 11 cases, which are often the most efficient in-court alternatives from a time and cost perspective, reserve much of the heavy lifting for the pre-filing period. Specifically, in connection with implementing a pre-packaged Chapter 11 plan, the company will typically identify significant holders of its "fulcrum" funded debt instrument (i.e., the creditor class or classes who would most naturally equitize or otherwise drive negotiations) and begin discussing key economic terms of a restructuring transaction, including (i) class-specific recoveries, (ii) forms of consideration (e.g., cash, common equity, preferred equity or new indebtedness) and (iii) any new money bridge or exit financing, as necessary. Customarily, the company and these significant creditors document the terms of any agreed-upon transaction through a restructuring support agreement (an "RSA") and, later, a Chapter 11 plan. Importantly, in light of the compressed time frame and desire to achieve consensus across all stakeholder classes, trade creditors will customarily be left unimpaired — that is, they will either receive payment in full under, or otherwise remain unaffected by, the plan.

Often a pre-packaged plan is the ideal strategy to be used when there is one or more impaired accepting classes and the class voting provisions are used to drag along the holdouts in the class. A major intercreditor dispute over value and claim treatment does not typically lend itself to a quick pre-packaged process.

A pre-packaged plan process may be "dual-tracked" with an out-of-court exchange offer in order to disincentivize holdouts and ensure certainty of outcome. Mechanically, in a dual-track process the company would typically seek simultaneous creditor approval of the out-of-court exchange offer and a pre-packaged plan. If the targeted percentage of consents to the exchange are received (often 90 percent or more), the company would consummate the transaction out-of-court. If such consents are not received, but class-by-class Chapter 11 voting thresholds are otherwise met (i.e., at least two-thirds in amount and more than one-half in number), then the company would file for Chapter 11 with the goal of expediently consummating the transaction in-court. The prospect of a Chapter 11 filing and potentially lower recoveries often leads to a higher rate of consents to the out-of-court exchange, potentially addressing the holdout dilemma.

Perhaps the most enticing aspect of a pre-packaged Chapter 11 is its speed. The duration of a typical pre-packaged Chapter 11, from the filing date to confirmation of a plan, is 30-60 days. Certain debtors, however, have recently succeeded in accelerating that timeline significantly, with some confirming a Chapter 11 plan in less than 48 hours. However, these "super" pre-packaged Chapter 11 filings are generally the exception rather than the norm and are filed by debtors with relatively simple capital structures and little need to rightsize their operations, paving the way for streamlined negotiations and substantial creditor consensus.

Considerations

A pre-packaged process comes with a myriad of benefits. For one, it minimizes time spent in bankruptcy court, thereby avoiding potential operational interference and degradation of brand value, as well as certain court-mandated disclosure obligations. As to the latter consideration, and by way of example, applicable bankruptcy rules require that debtors file highly detailed schedules of assets and liabilities as well as monthly operating reports. Given the limited duration of pre-packaged Chapter 11 cases and likely unimpaired treatment of trade creditors, these requirements may be inapplicable or otherwise waived. Relatedly, with limited time under court supervision, management and the board's resources may be largely devoted to ordinary course operational initiatives and oversight, as opposed to additional bankruptcy court filings and court appearances. Meanwhile, trade creditors, who should be largely unaffected by the filing and administration of a pre-packaged Chapter 11, will very likely maintain their usual course of dealing with the debtor, thereby minimizing or eliminating operational interruptions.

With reduced disclosure obligations and less time in-court comes reduced fees and costs. This reduction becomes even more significant where a creditors' committee has not been appointed by the U.S. Trustee (often referred to as the Department of Justice's "bankruptcy watchdog"). A debtor's Chapter 11 estate is required to pay the reasonable fees and costs of any creditors' committee's professionals retained pursuant to bankruptcy court order. In pre-packaged cases where trade creditors are unimpaired and therefore deemed to accept the plan, the U.S. Trustee regularly elects to forego appointing a creditors' committee, which would otherwise result in both increased costs and a materially higher risk of plan-related litigation and inter-creditor disputes.

Pre-packaged cases do, however, come with certain drawbacks, perhaps the most crucial of which is difficulty in utilizing Chapter 11's operational restructuring tools, such as the ability to estimate contingent claims, effect free and clear asset sales and assume or reject executory contracts — the latter of which can prove to be an especially valuable tool for debtors. With limited time in bankruptcy court and an expedited march toward confirmation, debtors often have insufficient time to rightsize their operational footprint through contract rejection and amendment or piecemeal asset sales, each of which may entail protracted litigation. For this reason, pre-packaged Chapter 11 cases are generally best suited for true balance sheet restructurings that do not have a complex operational component.

Pre-negotiated Chapter 11 cases

Mechanics

A pre-negotiated process often begins in the same way as a pre-packaged process — namely, the negotiation of an RSA with the company's fulcrum debtholders. After building as much consensus as possible across creditor classes, the debtors file Chapter 11 petitions, often along with a disclosure statement embodying the deal negotiated in the RSA. Often a pre-negotiated case (as opposed to a pre-pack) is commenced for one of three reasons (or a combination thereof): (1) The debtor has run out of time to formally solicit acceptances prior to a pending event of default, (2) the debtor cannot afford to leave trade claims unimpaired (and instead is seeking to haircut such claims) or (3) the debtor requires some time to address certain operational issues, as discussed below.

Upon the commencement of the case, the debtor will move the court to approve the disclosure statement. Only after the disclosure statement is approved (typically 30 days or so into the case) is the debtor authorized to solicit votes on its Chapter 11 plan. The solicitation period of approximately 30-35 days may promptly be followed by a confirmation hearing, often within a week following the termination of the voting period. As in a pre-packaged scenario, pre-negotiated Chapter 11 cases are typically filed after the debtor has secured the support of at least one impaired accepting class, thereby streamlining the confirmation process.

Given additional time in bankruptcy court — and the attendant prospect of creditor interference and enhanced execution risk — the RSA becomes particularly important in pre-negotiated cases. An RSA typically serves to "lock up" the debtor and its supporting creditors to an agreed-upon transaction structure and expedited Chapter 11 timeline through various commonplace terms, including, among others:

- the supporting creditors' agreement to vote in favor of a corresponding Chapter 11 plan;
- the debtor's agreement to a limited no-shop, often preventing it from actively pursuing or negotiating an alternative transaction (subject to a fiduciary out);
- the supporting creditors' agreement to sell their claims only to transferees that commit to be bound by the RSA; and
- various "milestones" inuring to the benefit of the supporting creditors, which obligate the debtor to achieve certain key Chapter 11 goals by specific points in time.

Crucially, some of the foregoing terms may be used as leverage against dissident stakeholders to ensure the debtor's chosen transaction structure remains undisturbed. For instance, transfer restrictions could work to prevent aggrieved creditor groups from building their holdings in order to acquire a blocking position within a given class. Milestones, on the other hand, often result in an event of default or termination right if breached. As such, courts are often wary of entertaining extensive litigation or pushing out briefing deadlines in fear of potentially eliminating the debtor's most viable path out of bankruptcy.

Considerations

Pre-negotiated cases, which may initially serve as a backup plan in the event that a pre-packaged path fails, offer debtors a blend of efficiency and flexibility. Successful pre-negotiated cases often span only 60-90 days from filing to confirmation, although it is not uncommon for such cases to have longer durations, particularly if the plan receives significant objection from non-supporting stakeholders. In any event, this timeline keeps fees and costs under control, while also limiting potential value degradation and operational interference that may come with extended time in Chapter 11. Indeed, compared to complex or contentious free-fall Chapter 11s, which have been known to last longer than a year's time, a pre-negotiated path is notably more expedient.

At the same time, a brief stay in Chapter 11 affords the debtor breathing space to center on an optimal restructuring strategy without the threat of creditor enforcement action (by operation of the automatic stay). With a couple of months or more in Chapter 11, the debtor may conduct certain operational restructuring initiatives that a pre-packaged process may not be able to accommodate, potentially including the rejection or renegotiation of burdensome long-term contracts. In short, a company that is able to build considerable creditor consensus before it needs to file would be wise to consider a pre-negotiated path in order to preserve maximum optionality.

Free-fall Chapter 11 cases

Mechanics

It is not always feasible to garner sufficient advance creditor support to pursue a pre-packaged or pre-negotiated Chapter 11 filing. The company may simply hit a liquidity wall, preventing it from making payroll or other critical payments. Or, a company in default under its debt facilities may have to file promptly in order to stay enforcement remedies, such as sweeping cash or replacing board members (depending on what the debt documents provide). Companies facing unexpected and potentially catastrophic litigation claims may also be required to consider a free-fall filing. In such situations, even without advance creditor support, the company's board of directors and management may reasonably determine that a Chapter 11 filing is necessary to preserve the company's business.

Without advance stakeholder support for the company's restructuring strategy, additional delay in exiting bankruptcy is inherent. However, expediency should still be a driving consideration as the company navigates Chapter 11. In fact, expediency is built into the Bankruptcy Code and may be required by the bankruptcy court. For example, in any Chapter 11 case, the debtor has the exclusive right to file a Chapter 11 plan for 120 days after the petition date. This effectively keeps the debtor in control of negotiations because it precludes the filing and solicitation of competing plans. This period can be extended up to 18 months after the petition date. However, after some period of time without progress toward a consensual restructuring, both stakeholders and the bankruptcy court may refuse to condone further extensions, requiring the debtor to proceed toward confirmation of a plan, at risk of otherwise losing control of its restructuring efforts. Further, any order authorizing the debtor to use cash collateral or to borrow debtor-in-possession ("DIP") financing typically sets milestones (such as a deadline to complete a sale or to file and confirm a plan) that if tripped can have dire consequences for the company. As a result, a debtor does not have an unlimited amount of time to negotiate and implement its path to exit.

In a free-fall bankruptcy, the ultimate goal for the debtor should be no different than in a pre-packaged or pre-negotiated Chapter 11 case — to obtain sufficient creditor support to confirm a Chapter 11 plan. Even if all classes of creditors are not immediately in agreement with the debtor's first Chapter 11 plan proposal, obtaining sufficient stakeholder support to cram down a plan on dissident stakeholders (including the support of an impaired accepting class) can help drive negotiations to consensus. The path toward exit is often iterative, and a lack of unanimous creditor support for the debtor's first plan proposal should not hinder its restructuring efforts.

Considerations

Free-fall Chapter 11 filings can take any size or shape. However, there are at least three common themes that management should consider if a free-fall filing becomes necessary or advisable.

First, it is critical to develop a realistic timeline for the company to emerge from bankruptcy. This will be in part influenced by the debtor's plan exclusivity period or case milestones. But more importantly, this will be driven by the debtor's liquidity position. If the debtor is projecting that it will run out of cash in a certain month following the petition date, and it is unable to borrow additional money, then the debtor's restructuring plan must account for this timeline.

Second, the debtor's management and advisors should immediately identify stakeholder groups who may sign on to the debtor's restructuring efforts and whose support can drive confirmation of a plan over the objection of dissident creditors. This is critical to implementing a restructuring strategy that minimizes time in bankruptcy.

Third, the debtor should pick its battles. In many Chapter 11 cases, some level of litigation regarding the debtor's or creditors' rights is necessary before the debtor can ultimately confirm a Chapter 11 plan. However, in assessing litigation strategy, the debtor must always be cognizant not only of cost, but also of how that strategy fits into its broader restructuring plan.

Conclusion

A company's restructuring efforts are subject to a wide variety of influences, some of which may be out of the company's control. However, with limited (if any) exceptions, there is one universal truth: If a company requires the assistance of the bankruptcy courts to reorganize, a shorter stay in bankruptcy will preserve value and put the company in a better position upon emergence. Developing an early exit strategy is critical, as is flexibility if unforeseen hurdles occur. And, of course, careful and diligent management of the bankruptcy case and creditor relations is equally important to ensure that strategy remains on track. With the assistance of experienced advisors, a company may develop an optimal Chapter 11 strategy designed to both minimize time in bankruptcy and ensure that management is able to achieve its goals.

10 TREATMENT OF WORKFORCE-RELATED CLAIMS IN FINANCIAL RESTRUCTURINGS

LEGAL PERSPECTIVE

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When a company is in financial distress, boards and senior leadership teams confront difficult choices, particularly in managing human capital. If a company seeks bankruptcy protection, having a clear and comprehensive labor strategy can help maintain employee morale, minimize potential disruptions and preserve the value of the enterprise. Developing such a strategy requires understanding the ways in which the U.S. Bankruptcy Code and courts treat employee-related claims. This chapter will cover three workforce-related claims—those arising from (i) the Worker Adjustment and Retraining Notification Act ("WARN Act"), (ii) severance programs and (iii) withdrawal from multi-employer pension plans—that, if not adequately planned for, can result in significant and potentially unnecessary liabilities.

How the bankruptcy code classifies claims

Before examining issues related to these types of labor claims, it is necessary to understand how the Bankruptcy Code generally classifies and prioritizes claims against a debtor and its estate, and the distinction between pre- and post- petition claims. Claims generally may be placed into three primary categories:

— **Secured claims**: A claim is secured to the extent of the collateral's value. A creditor with a secured claim is entitled to priority payment out of its collateral. If the collateral value is less than the claim amount, the "deficiency" is treated as an unsecured claim.

— **Priority claims**: Under Bankruptcy Code section 507, ten categories of unsecured claims and expenses are entitled to payment priority in bankruptcy cases. Relevant to the workforce claims discussed herein are the second and fourth priorities: (i) administrative expenses, under Bankruptcy Code section 507(a)(2) and (ii) wage, salary and commission claims, under Bankruptcy Code section 507(a)(4).

— **Unsecured claims**: Claims that are not secured by collateral and are not entitled to priority are general unsecured claims and will receive a ratable distribution of the value remaining in the debtor's estate after satisfying senior claims.

The foregoing classifications are important because they affect how workforce-related claims are treated. Equally significant to the treatment of these claims is whether the claims represent a pre-petition or post-petition liability.

— **Pre-petition wages and benefits**: Priority for wages and benefits earned pre-petition has been a long-standing feature of U.S. bankruptcy law. This priority, currently codified in Bankruptcy Code section 507(a)(4), elevates what otherwise would be an employee's unsecured claim to a preferred status — providing employees greater assurance that their wages will be paid and generally encouraging employees to remain working for the bankrupt company. The amount entitled to priority under this provision, however, is capped (though bankruptcy courts often allow a debtor to exceed such cap). Currently, this cap is $15,150 per employee and is adjusted every three years to account for changes in the cost of living. Additionally, for any wages or benefits to qualify for the priority, they must have been "earned" within 180 days of the petition date. All pre-petition wages and benefits that exceed the cap or were earned more than 180 days prior to the petition date are not entitled to priority. Instead, they are treated as general unsecured claims in the bankruptcy and a debtor is not required to pay such claims in full in cash.

— **Post-petition wages and benefits**: Claims arising after a debtor's petition date, including wages and benefits, are "administrative expenses" as they represent "actual, necessary costs and expenses of preserving the estate[,]" and are granted a second priority under section 507(a)(2) of the Bankruptcy Code. This priority ensures that, unless otherwise agreed with the claimant, administrative expenses are paid in full and in cash on the effective date of a Chapter 11 plan. Unlike pre-petition claims, the requirement to pay such claims in full and in cash can represent a significant restraint on a debtor's liquidity.

In sum, when considering workforce-related claims in bankruptcy, timing is critical.

Warn act claims

Enacted in 1988, the WARN Act, 29 U.S.C. §§ 2101 *et seq.*, protects employees affected by job loss due to "plant closings" and "mass layoffs." The WARN Act requires employers with 100 or more employees (which may, under limited circumstances, include part-time employees) to provide 60 calendar days' notice of any plant closing (including a permanent or temporary shutdown of a single site of employment or one or more facilities or operating units within such single site of employment) affecting 50 or more employees, or any mass layoff (such as a reduction in force at a single site of employment) that affects at least 50 employees, if such number represents at least 33% of the total workforce, or at least 500 employees, regardless of the percentage of the workforce impacted. When determining whether a plant closing or mass layoff has occurred, employment losses are measured during a rolling 30-day period and part-time employees are not included. If an employer fails to give its employees the full 60-days' notice, the employer will be liable to affected employees for back pay and benefits for each day of its violation. Depending on the size of the workforce reduction and the length of the violation, these damages can be significant. For employers on the brink of insolvency or already in bankruptcy, the treatment of WARN Act claims could significantly affect how much, if any, value is left in the estate for distribution. The key consideration in determining whether such claims are entitled to priority is the timing of when the claim arises—meaning: is the claim for damages under the WARN Act properly viewed as a pre-petition claim or a post-petition administrative expense, entitled to payment in full in cash? Not all courts have adopted the same view.

Prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), case law regarding the treatment of WARN Act claims in bankruptcy was clear: damages under the WARN Act were treated akin to wages and were subject to the same priority. *See, e.g.*, *In re Kitty Hawk Inc.* (Bankr. N.D. Tex. 2000); *In re Hanlin Group* (Bankr. D.N.J. 1995); *In re Cargo, Inc.* (Bankr. N.D.

Iowa 1992). Courts in these cases likened WARN Act damages to a "statutorily imposed form of severance pay," similar to severance pay in lieu of notice. Severance pay in lieu of notice is deemed to accrue or vest at the time of termination, because entitlement to such pay is predicated on whether notice had been given before the moment of termination. Likewise, since the WARN Act is either violated or not violated at the time of termination, damages were found to accrue at termination as well. This understanding, in turn, meant that a termination within 180 days before the petition date that violated the WARN Act could at most qualify for payment priority up to the statutory cap (i.e., $15,150), with the remaining damages classified as general unsecured claims. Meanwhile, a post-petition termination in violation of the WARN Act would result in an administrative expense claim. Thus, the only consideration was whether the termination happened pre- or post- petition.

With the enactment of BAPCPA, this binary analysis hit a snag. BAPCPA expanded the types of claims allowable as administrative expenses to include wages and benefits awarded pursuant to judicial proceedings as "back pay attributable to any period of time occurring after commencement of [a bankruptcy] case … without regard to …whether any services were rendered." This amendment created a split among bankruptcy courts regarding how it applied to damages under the WARN Act, with two main approaches emerging to date.

The first approach adheres to the pre-BAPCPA case law set forth above. Courts following this approach look to the time when the WARN Act claims "vest or accrue." *See, e.g.*, *In re Powermate Holding Corp.* (Bankr. D. Del. 2008). These courts focus on the statutory phrase "attributable" and find that the time to which back pay is attributable is when the rights vest or accrue, without regard to when the unlawful conduct or services occurred or when payment is due. Thus, in keeping with the pre-BAPCPA line of cases, a claim for WARN Act damages for a pre-petition termination under this interpretation does not constitute an administrative expense claim, while a claim for WARN Act damages for a post-petition termination would. Whether the termination occurred before or after the petition date remains the relevant inquiry under this line of cases.

In contrast, courts following the second approach find that focusing on the timing of when rights vest or accrue is inconsistent with the plain language of the amendment. *See, e.g.*, *In re Truland Group, Inc.* (Bankr. E.D. Va. 2014); *In re Phila. Newspapers, LLC* (Bankr. E.D. Pa. 2010). These courts instead focus on whether any portion of the WARN Act liability period extends post-petition to determine whether any portion of the related damages constitutes an administrative expense. In making such determination, these courts rely on the language in the amendment that employees are entitled to an administrative expense "without regard to the time of the occurrence of unlawful conduct on which such award is based or to whether any services were rendered[.]" Under this approach, as long as the other requirements of the amendment are met, an award of back pay "attributable to any time occurring after the commencement of [a] case" constitutes an administrative expense. By way of example, these courts reason that if employees are terminated without any advance notice (and are not paid severance in lieu of notice to effectively preclude relief for damages), the 60-day liability period begins on the date of such termination and ends 60 days later. If the bankruptcy petition was filed five days after the employees' termination, then 55 days out of the 60-day liability period occurred after the commencement of the case. Thus, the 55-day period attributable to the post-petition period will be considered an administrative expense and entitled to payment in full, in cash.

When considering a workforce reduction in or near bankruptcy, an employer should keep in mind the following:

— **WARN Act compliance**: Employers should, if feasible, adhere to the WARN Act's 60-day written notice requirement. In the event of uncertainty regarding whether a plant closing or mass layoff will occur, or whether certain employees may be impacted by such events, employers should err on the side of caution and provide the required notices since they may be withdrawn should circumstances change. Employers should also be aware of the exceptions to the WARN Act's notice requirement, which include the Faltering Company, Unforeseeable Business Circumstances and Natural Disaster exceptions. However, even when an exception applies, notice of termination must still be provided to employees as soon as possible. In addition, some states have enacted their own versions of the federal WARN Act, colloquially referred to as "mini-WARN Acts." Companies should review applicable state mini-WARN Acts if they anticipate any material workforce reductions.

— **Timing of workforce reduction**: If it is not possible to provide advance notice to employees of a plant closure or mass layoff, employers should consider both the timing of any workforce reduction and the jurisdiction of the bankruptcy court in which proceedings may be filed or pending because these may affect whether or not a WARN Act claim receives administrative expense status in bankruptcy. To date, there is no binding circuit-level precedent on how to interpret the BAPCPA amendment and different bankruptcy courts within the same jurisdiction have taken opposing views.

Severance claims

Severance benefits fall within the employee-priority set forth in Bankruptcy Code section 507(a)(4). Generally, employers pay severance to employees under three scenarios: (i) as compensation for job loss, with the benefit amount typically calculated based on years of service; (ii) as a payment in lieu of notice of termination; or (iii) under an employment contract, with the severance payment typically due if the employee is terminated without cause prior to expiration of the contract period. No universal rule exists on when severance is "earned," so care should be taken in considering the general approach in the applicable jurisdiction and the terms of any severance plan or employment contract. Nonetheless, the following are guidelines based on case law for considering the amount of liability a debtor may have for severance payments under the different types of severance.

— **Severance based on years of service**: For employees terminated post-petition, courts reason that, because an administrative expense claim must be supported by "services rendered after the commencement of a case," severance payments based on length of employment are entitled to administrative expense status only to the extent accrued during post-petition employment. Accordingly, courts will award administrative expense priority only to the portion of a severance award attributable to post-petition services, with the balance either (i) eligible for pre-petition priority if earned within the 180-day time period (up to $15,150) or (ii) a general unsecured claim for any amounts outside of the 180-day time period. By contrast, for employees terminated pre-petition, courts have reached differing results on when severance based on years of service is "earned" for purposes of calculating the portion attributable to the 180-day period. Some courts, including the Court of Appeals for the Fourth Circuit in *Matson v. Alarcon* (4th Cir. 2011), have concluded that no right to severance exists until an employee is involuntarily terminated — and thus, the full amount is earned upon termination. The Fourth Circuit reasoned that the entitlement to severance pay was triggered by the employer's decision to terminate the employment relationship (not by the employee's rendering of services) and, moreover, the board at all times retained the right to eliminate the severance program before employees became entitled to payments. The Fourth Circuit remains the only circuit that has addressed the question of when severance based on length of service is "earned," with other lower-level courts split in approach (i.e., whether the full amount of severance is earned at termination or whether the severance should be prorated). As the Fourth Circuit's decision indicates, how a court views severance may be informed by the terms of the applicable compensation plan and the specific rights that exist between the parties.

— **Severance in lieu of notice**: Courts recognize that, with severance in lieu of notice, the entire severance benefit is earned on the date of termination. This payment is considered earned at termination since no right to any severance benefit exists unless the termination occurs. Accordingly, for this type of severance, the amount of liability can be determined simply by reference to the termination date. If the termination occurs post-petition, the full amount will be granted administrative expense priority and entitled to payment in full in cash. If the termination occurs pre-petition and within the 180-day time period, up to the statutory cap of $15,150 will be entitled to priority, with the balance classified as a general unsecured claim. For any termination outside the 180-day time period, the employee will have only a general unsecured claim.

— **Severance under employment contracts**: For severance under an employment contract, courts have held that the severance payment was earned upon execution of the contract, rather than the termination date. For example, the Court of Appeals for the First Circuit, in *Mason v. Official Committee of Unsecured Creditors (In re FBI Distribution Corp.)* (1st Cir. 2003), upheld denial of administrative expense priority to an executive's severance benefit following a post-petition termination by reasoning that the executive provided the consideration supporting the severance payment pre-petition by forgoing other employment opportunities. The same reasoning applies in connection with pre-petition terminations and identifying whether the contract was executed within the 180-day time period and therefore "earned" at that time.

Finally, with respect to employment contracts, employers should also be aware that Bankruptcy Code section 502(b)(7) caps an employee's claim for severance at a year's compensation, starting from the earlier of (i) the date the bankruptcy case began or (ii) the termination of the employee's contract.

In addition to the foregoing, employers should keep in mind an additional restriction on severance. Severance claims by an "insider" (generally, for corporate debtors, meaning directors and officers) are limited by Bankruptcy Code section 503(c)(2). This provision requires that any severance payment to an insider must (a) be part of a program generally applicable to all full-time employees and (b) not be greater than ten times the amount of the mean severance pay given to non-management employees during the calendar year in which the payment is made.

Given these varied approaches on severance, it is important to develop a workforce reduction and severance strategy prior to filing a petition. Employers and their counsel should carefully evaluate (i) the state of the law in the potential filing jurisdictions, (ii) the terms of any severance plan or contract providing for severance, including whether such plans or contracts may be amended or replaced and (iii) the timing of terminations or workforce reductions that may give rise to severance obligations to minimize potential liabilities.

Withdrawal liability

Withdrawal liability can arise when an employer participating in a multi-employer pension plan exits that plan. Often a withdrawal occurs because the employer ceases to fulfill its obligations under a pension plan or discontinues its operations covered by a plan. The Employee Retirement Income Security Act of 1974 ("ERISA"), 29 U.S.C. §§ 1001 *et seq.*, as amended by the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), 29 U.S.C. §§ 1381 *et seq.*, imposes liability for withdrawals because, without payment of that liability, other contributing employers must shoulder increased funding obligations, leaving plans susceptible to failure.

An employer's withdrawal liability represents its share of the plan's unfunded vested benefits, which is "calculated as the difference between the present value of vested benefits and the current value of the plan's assets." *Pension Benefit Guar. Corp. v. R.A. Gray & Co.* (1984). The MPPAA sets out various formulas that plans can use to calculate the portion of unfunded vested benefits attributable to a given employer. This means when an employer withdraws, the pension plan trustee calculates the total unfunded vested benefits, determines the withdrawing employer's allocable share using a certain formula under the MPPAA and collects the portion of unfunded vested benefits attributable to the withdrawing employer. The calculation of unfunded vested benefits can be complicated by many other factors, including, for example, whether the employer's liability obligation is due in a lump sum or installments, whether a payment cap applies or whether an employer is assessed with multiple partial withdrawals.

The primary question that arises with respect to withdrawal liability claims in bankruptcy is the allocation of the claim among administrative expense priority and general unsecured status. Courts that have addressed this issue have come to varying conclusions, with some denying administrative expense status altogether, such as courts in the Sixth Circuit, and others allowing administrative expense status for the portion of withdrawal liability claims that are attributed to the post-petition period, including courts in Second and Third Circuits.

In line with the jurisprudence that denies administrative expense status altogether, the Bankruptcy Appellate Panel for the Sixth Circuit denied administrative expense priority for any portion of a withdrawal liability claim, even though the debtor continued operations two years post-petition during which contributions were made to the plan based on the work of employees. *See In re HNRC Dissolution Co.* (6th Cir. B.A.P. 2008). The court found that the calculation of the withdrawal liability claim included factors such as discount rates and market fluctuations that were not connected to post-petition work and so not entitled to administrative expense priority.

In contrast, the Court of Appeals for the Third Circuit apportioned liability between pre- and post- petition periods. *See In re Marcal Paper Mills, Inc.* (3d Cir. 2011). The Third Circuit found that the employees were required to work to keep the employer in business and consequently conferred a benefit to the estate. As a result, the Third Circuit held that the portion of liability attributable to post-petition work was entitled to administrative priority.

Notwithstanding the determination by some courts that a portion of withdrawal liability may be classified as an administrative expense, given the complexities of determining apportionment, it is the *amount* of such withdrawal liability that should be treated as an administrative expense that is likely an issue that will be subject to significant litigation in the bankruptcy courts. Besides *In re Marcal Paper Mills*, only two other circuit court decisions have addressed whether post-petition withdrawal liability can be classified as an administrative expense, and neither directly decided the issue of the allocation of claims between administrative and unsecured status. *See Food Employers' Labor Rels. Ass'n v. A&P* (2d Cir. 2015) (finding that the plan's calculation of withdrawal liability bore little if any relation to the amount of unfunded vested benefits from the plan year in which the bankruptcy petition was filed); *Trustees of Amalgamated Ins. Fund v. McFarlin's* (2d Cir. 1986) (holding that the withdrawal liability claim was only supported by pre-petition labor). Although many courts appear to agree that withdrawal liability claims should be prorated between the pre- and post- petition periods based on how much an employer's unfunded obligations increased during the plan year, those courts still question how to appropriately apportion the withdrawal liability claim amounts between pre- and post- petition periods. *In re Marcal Paper Mills*; *In re Cott Corp.* (Bankr. D. Ct.); *In re Pulaski Highway Express, Inc.* (Bankr. M.D. Tn. 1986).

Because courts differ in how they assess whether a portion of withdrawal liability claims are entitled to administrative expense status and, if so, what manner of calculation appropriately allocates such portion of a withdrawal liability claim to post-petition labor, it is essential to pay careful attention to the jurisprudence of the potential filing jurisdictions. Employers planning for bankruptcy should be aware of whether or not any withdrawal liability will be or could be incurred and should take the necessary steps to calculate the potential claim amounts.

Conclusion

Rarely do companies in financial distress have the luxury of time. But having a clear workforce strategy is among the most important tasks a board and senior leadership team can undertake in advance of a bankruptcy filing. Careful attention to the particular rules of a jurisdiction — particularly if a company has options on where to file its bankruptcy petition — and the various timing considerations for labor-related claims can help ensure a smooth, value-maximizing Chapter 11 process for all stakeholders.

11 MEDIATION TO ACCELERATE RESOLUTION AND REDUCE COST IN BANKRUPTCY

LEGAL PERSPECTIVE

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Mediation to resolve plan-related and other disputes in Chapter 11 has proliferated in recent years, and for good reason. As seen with debtors like JCPenney, Windstream Holdings Inc., Frontier Communications, Puerto Rico and Tribune Company, mediation can resolve complex, multiparty disagreements, paving the way for a debtor's emergence from bankruptcy. When faced with seemingly intractable, complicated disputes that routinely beset corporate debtors, mediation can be a uniquely helpful tool for directors and officers ("D&O") as they attempt to manage stakeholders with competing interests, guide their company through bankruptcy, preserve jobs and maintain business operations. Unlike litigation, which results in a binary outcome in favor of one party and the prospect of appeals, mediation allows participants to craft creative, multiparty solutions that propel a debtor towards plan confirmation and out of bankruptcy. While litigation occurs in public, subjects parties to rigid rules and ends with a binding, judicially determined outcome, mediation is held in private, under the guidance of a neutral mediator who creates a bespoke process intended to facilitate voluntary dispute resolution. As a result, when embroiled in a contested Chapter 11 process or discrete adversary proceeding, corporate debtors and their stakeholders may view mediation as worthwhile, or even necessary.

This article examines mediation as a dispute resolution tool in Chapter 11 cases and offers considerations for debtors contemplating mediation.

Background

Compromise is a hallmark of Chapter 11. But with a constellation of stakeholders — secured lenders, unsecured bondholders, trade creditors, employees, unions and governmental agencies, among others — these cases often spawn wildly expensive, time-consuming and distracting litigation. Although a party to a bankruptcy dispute may have good reason to be aggressive and press for judicial resolution in its favor, it also must recognize the uncertainty of prevailing in-court, particularly when the dispute involves pivotal, fact-intensive controversies such as valuation or novel issues of law with no clear, let alone binding, precedent. And with this uncertainty comes the inherent risk that one party will be on the losing side of a binary outcome, with the winner facing the prospect of one or more appeals. Litigants in such a dispute may request — or the presiding bankruptcy judge may suggest or even order — that mediation, rather than litigation, may more effectively and efficiently resolve the issues at hand.

Chapter 11 mediation is voluntary, nonbinding and takes place off the record — out of view of the judge presiding over the bankruptcy case. The mediation process and structure vary from case to case depending on the nature of the issues, personality and preferences of the mediator and number of parties participating. It is a flexible, not formulaic, exercise. Mediation typically involves separate meetings, phone calls and videoconferences to keep the dialogue open and to encourage parties to evaluate the strengths and weaknesses of their (and other parties') positions, foster creativity and, ultimately, compromise. It can last days, weeks or months, depending on the time allotted and the complexity of the matter being mediated. Participants usually include principals of, and advisors to, parties with a stake in the outcome of the dispute and can change over time as the dispute evolves.

In mediation, the mediator can offer his or her views on the dispute and the parties' positions and predict how the court will resolve the dispute if the parties do not reach an agreed outcome. Mediators often meet privately with individual parties, or groups of parties, to understand their motivations and willingness to compromise. This allows a more realistic assessment of the benefits to settling and the risks of a failed mediation.

As one recent example, telecommunications provider Windstream Holdings Inc.'s bankruptcy mediation stands out for its complexity and duration. The mediation, overseen by a sitting bankruptcy judge as mediator, involved nearly a dozen parties and spanned several months with the goal of reaching a possible settlement with the debtors' lessor, Uniti Group Inc., over the terms of a master lease critical to Windstream's business. In August 2019, the debtors and their key creditor stakeholders commenced mediation with Uniti. The mediation did not initially succeed and was suspended indefinitely in November 2019 when the parties reached an impasse. However, the mediation resumed in January 2020, and the debtors, their first lien lenders (among other parties) and Uniti ultimately reached an agreement in principle regarding the master lease and terms of a Chapter 11 plan. The debtors later revisited mediation to attempt to resolve certain plan objections, including those by the Official Committee of Unsecured Creditors. The plan that emerged from these negotiations, while not fully consensual, enjoyed broad support, was confirmed and ultimately allowed the company to emerge from bankruptcy more quickly than had the debtors' litigation with Uniti proceeded without mediation.

What follows is a look at some important considerations for D&O evaluating whether to utilize mediation in large Chapter 11 cases.

Mediation considerations

Choosing to mediate

"To mediate or not to mediate?" is a paramount question for a company's D&O when faced with disputes in bankruptcy. And timing is critical. While parties need not be trial-ready, to maximize the chances of mediation success, the parties should have sufficiently developed their cases and exchanged enough information about the allegations and defenses — typically including at least some discovery — to understand each other's positions. Often by this point, mediation will be an obvious option, as parties may have hardened their positions or ceased constructively communicating, resulting in a shared understanding that compromise is needed if a trial is to be avoided.

On the other hand, when parties lack a shared belief that the dispute is ripe for settlement, mediation is unlikely to be successful. For example, in the bankruptcy of Johnson & Johnson's subsidiary, LTL

Management LLC, the court denied the debtor's request to mediate with its personal-injury claimants related to its talc liabilities until it resolved the claimants' request to dismiss the Chapter 11 case on the grounds that the company acted improperly by attempting to resolve such liabilities in Chapter 11. Prior to the debtor's request to mediate, the claimants, through an Official Committee of Talc Claimants, filed a statement expressing concerns with the bankruptcy and announcing their intention to seek dismissal of the case as a bad-faith filing and subsequently filed a motion to dismiss. The judge, a self-described "advocate for mediation," recognized that "mediation has to be undertaken in a cooperative endeavor" and explained that he would rather the parties "have their hearts and soul into mediation" before going down that path. (See *In re LTL Management LLC*, Case No. 21-30589 (MBK) (Bankr. D.N.J. Nov. 22, 2021), Nov. 22, 2021 Hr'g Tr. at 60:9, 60:14–15, 61:10–11.)

Selecting the mediator

Mediator selection is a key step in the process and usually involves agreement of the parties, although sometimes a court will impose its own choice or strongly suggest someone. Certain courts, including the bankruptcy courts for the Southern District of New York and the District of Delaware, where many large Chapter 11 cases are filed, maintain pre-approved lists from which to select a mediator. Alternatively, parties may propose a mediator, a pool of mediators or a process by which to select a mediator. While mediation typically involves one mediator, in the Chapter 9 case *In re City of Detroit*, the presiding judge in the bankruptcy court for the Eastern District of Michigan appointed a chief mediator to oversee a panel of mediators, with each mediator focusing on a subset of issues. Whatever the selection method, the presiding judge must approve the mediator.

Potential mediators are screened by the parties to the dispute based on their experience, reputation, personality, mediation style and availability. Applicable local or chambers rules may also provide mediator requirements. If the issues to be mediated are particularly complex and are expected to be time-consuming, the potential mediator's schedule will also be a focus. Current bankruptcy judges are often favored mediators, particularly those sitting in the same district as the judge presiding over the bankruptcy case. For example, the two judges presiding over complex Chapter 11 cases filed in the Southern District of Texas have developed a practice of appointing each other as mediator over disputes arising out of their cases. Not only do sitting judges bring to bear their expertise in resolving similar disputes, but they also afford credibility to the process — and, critically, to any mediated outcome they approve. Alternatively, parties may select a retired bankruptcy judge or private mediator with relevant expertise.

Confidentiality concerns

Confidentiality is at the heart of every mediation. In stark contrast to the open and public nature of bankruptcy cases and adversary proceedings, mediation requires privacy to be successful and, therefore, is conducted entirely off the record. This confidentiality encourages candid, good faith bargaining and equips the mediator to offer a neutral assessment to each party of the strengths and weaknesses of its arguments, the dispute's likely outcome and potential settlement options. The Second Circuit Court of Appeals has recognized the importance of confidentiality during mediation, observing that, "If participants cannot rely on the confidential treatment of everything that transpires during these sessions then counsel of necessity will feel constrained to conduct themselves in a cautious, tight-lipped, non-committal manner more suitable to poker players in a high-stakes game than to adversaries attempting to arrive at a just resolution of a civil dispute." (See *Lake Utopia Paper Ltd.* v. *Connelly Containers, Inc.*, 608 F.2d 928, 930 (2d Cir. 1979).)

Mediation orders and related procedures typically provide that all communications and submissions, including settlement proposals, made by a mediation party in connection with the mediation are protected from disclosure, shall not constitute a waiver of any applicable privilege and are not admissible for any purposes in any judicial or administrative proceeding. The mediation itself is governed by a mediation privilege unless the parties agree to disclosure, or a disclosure is required by law.

Parties participating in the mediation will likely have to execute confidentiality agreements with the debtors or other key mediation parties, particularly where commercially sensitive or material non-public information ("MNPI") will be exchanged. In cases where the debtor's investors are mediation participants, confidentiality agreements typically require the investors to relinquish their ability to buy and sell securities in exchange for access to MNPI in the mediation. The delicate balance between the desires for investment liquidity and informational transparency often leads to a detailed negotiation over the terms of the confidentiality agreement. As a result, confidentiality agreements often contain "cleansing" obligations that require the debtor to publicly disclose any MNPI that was shared during the mediation, and whether an agreement has been reached — and, if so, the key terms thereof — or whether the discussions have ceased or mediation has terminated without an agreement. In spite of these cleansing procedures, investors remain cautious in managing their exposure to MNPI and may only want to restrict themselves once the mediation has progressed sufficiently for their advisors to recommend that they restrict.

The *Washington Mutual* case is instructive. There, the debtors' investors participated in mediation over a dispute regarding ownership of certain assets following a sale to JPMorgan and agreed to receive MNPI during a trading restriction period. While the debtors disclosed what they believed to be the MNPI at the end of the trading restriction period, the bankruptcy court for the District of Delaware found that there were colorable claims that the debtors' investors had improperly traded while in possession of MNPI due to the investors' receipt of rejected settlement proposals that were not ultimately disclosed. The court also held that the investors may have assumed special duties as non-statutory insiders of the debtors through their participation in the mediation. While *Washington Mutual* was subsequently vacated and mediation orders negotiated since then often contain provisions to address that court's concerns, it highlights the risks that investors consider before participating in mediation.

Defining success

From the debtor's perspective, a successful mediation is typically one that resolves disputes that have the potential to prevent the case from moving quickly and efficiently towards confirmation of a Chapter 11 plan and emergence from bankruptcy. For example, in *JCPenney*, the debtors sought to remain a going concern rather than liquidate, as is the fate of many retailers that have entered Chapter 11. To do this, the debtors proposed to sell their operating business to third parties and their real estate to their lenders, who would then lease the real estate to the operating business. The purchasers of the operating company and their potential lenders had difficulty agreeing on terms of the asset purchase agreement and the accompanying long-term master lease that would govern their ongoing relationship. With the encouragement of the presiding judge — and otherwise facing the prospect of liquidation — JCPenney turned to mediation. Under the guidance of a sitting bankruptcy judge serving as mediator, the parties reached agreement and the sale proceeded.

Mediation, however, need not resolve all disputed issues between parties to be successful or benefit the debtor. Because mediations in large restructuring cases often involve multiparty disputes, it may be difficult to resolve all disputes in a single mediation. The failure to reach global resolution does not necessarily mean that mediation has failed: narrowing the disputed facts and legal issues creates direction, efficiencies and momentum. Additionally, if the dispute does not settle as a result of mediation, mediation affords each party an opportunity to test its theory on the mediator and other parties, which may lead to fine-tuning, wholesale changes in strategy or a late settlement.

Conclusion

Mediation plays a significant role in complex Chapter 11 cases and can serve as a useful, even critical tool for D&O in effectively steering their companies through bankruptcy. Mediation's flexibility allows parties to tailor a dispute resolution process to meet the particular needs of a case, channeling resources into a collective effort that provides stakeholders with a confidential forum overseen by someone who is skilled and experienced at dispute resolution. While mediation may not achieve unanimous — or any — agreement and is likely to be contentious, lengthy and trying, it can be an invaluable tool for corporate debtors to consider when facing disputes in Chapter 11 cases.

12 THE BACKSTOP RIGHTS OFFERINGS: SECURING CAPITAL DURING YOUR RESTRUCTURING PROCESS

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When a Chapter 11 debtor seeks to emerge from bankruptcy through a plan of reorganization[1] it must demonstrate feasibility by, among other things, showing sufficient funding for its go-forward, reorganized operations. Some or all of this funding can come through a rights offering — in which the reorganized debtor issues debt or equity instruments to raise funds. Backstop agreements have become a frequent companion to bankruptcy rights offerings and commonly involve existing creditors or equity holders guaranteeing that the rights offering will be fully subscribed by agreeing to purchase any unsubscribed rights in exchange for a fee.

This chapter provides an overview of how backstop agreements are utilized in Chapter 11 bankruptcy cases, addresses common critiques of backstop agreements and analyzes recent trends in backstop agreements through the lenses of both case law and key terms in the underlying backstop agreements.

Overview of backstop agreements

The rights offering

If a debtor elects to obtain exit funding in full or in part through the issuance of new equity[2] or debt instruments, it will seek bankruptcy court authorization to conduct

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[1] Alternatives to a Chapter 11 plan of reorganization include a sale of substantially all assets under section 363 of the bankruptcy code or a plan of liquidation.

[2] Under section 1145(a)(1), securities in the reorganized company may be issued without traditional securities registration and compliance if securities are issued: (i) under a plan of reorganization; (ii) by the debtor, an affiliate of the debtor, or a successor to the debtor; and (iii) in exchange for claims against or interests in the debtor, or “principally” in exchange for such claims or interests and partly for cash or property. Section 1145(a)(2) also provides an exemption for offerings of securities through warrants, options, rights to subscribe, or conversion privileges when the original security is issued in compliance with section 1145(a)(1).

a rights offering in which a select group of creditors or existing equity holders may purchase the instrument being issued.[3] Participation in a rights offering is typically offered to all eligible claimants (typically those that meet certain accreditation requirements) in a particular class of claims on a pro rata basis. Participation is also usually solicited concurrently with (and as an inducement for a class of creditors to vote in favor of) plan confirmation. For this reason, court approval is most commonly sought in conjunction with the filing of the debtor's disclosure statement so that the debtor may work toward getting the rights agreement subscribed concurrently with obtaining the necessary votes for plan confirmation.

In order to incentivize participation in the rights offering, it is very common for the debt or equity instrument involved to be issued at a discount — sometimes a very steep discount — to the estimated enterprise value of the reorganized debtor. A debtor may subject its proposed rights offering to market testing, but this is not especially common and is not a legal requirement to obtain court approval of the backstop agreement.

Purpose, logistics and importance of backstop agreements

To ensure the necessary capital is raised via the rights offering, it is common for a debtor to enter into an agreement with either a third party or, much more commonly, a group of existing creditors or equity holders (who, many times, are also taking part in the initial rights offering). This is done to "backstop" the initial rights offering by agreeing to purchase any unsubscribed portion of the initial rights offering after the offering period expires. Backstop parties are compensated for undertaking the financial risk incumbent with backstopping a rights offering through fees that may be paid in cash, in kind with the instrument being offered, or a combination of both.

[3] It is also possible, in a circumstance where a debtor negotiates a restructuring support agreement or plan support agreement prior to bankruptcy, that a debtor will have the terms of a rights offering agreed when it enters bankruptcy.

Backstop agreements can provide a myriad of benefits to the debtor's bankruptcy estate, principally that the reorganized debtor can meet its post-bankruptcy capital requirements. To confirm a Chapter 11 plan, the debtor must establish plan feasibility, which requires the debtor to show that the confirmed plan is not likely to be followed by a liquidation or need for further financial reorganization — under Section 1129(a)(11) of the Bankruptcy Code. Backstop agreements ensure that the rights offering will be fully subscribed, providing committed financing for the reorganized debtor to establish the feasibility of its Chapter 11 plan.

Backstop agreements also play an important role in inducing support for the plan because, as expanded on in the next section, backstop agreements typically require the backstop parties to agree to vote in favor of the debtor's plan. Obtaining backstop support from existing creditors or equity holders — as opposed to obtaining third-party exit financing — can also boost recoveries for creditors and, thus, generate support for the plan. In this way, backstop agreements can, and often do, help generate consensus in Chapter 11 cases. Although backstop agreements are a mechanism typically employed in large Chapter 11 cases, there are few written opinions on the topic because of its ability to drive consensus, and where objections are made, it is common for consensual resolutions to follow.

Critiques of backstop agreements

Notwithstanding the fact that backstop agreements are commonly utilized and approved in Chapter 11 cases, they can be the subject of significant criticism most typically from creditors that are excluded from the opportunity to participate in backstopping the initial rights offering and would otherwise have wished to participate. The first type of common criticism argues that the use of a backstop agreement is inconsistent with provisions of the bankruptcy code that mandate that similarly situated creditors be treated the same and require that a Chapter 11 plan be proposed in good faith.

Payment of backstop fees to only some similarly situated creditors may allow a subset of creditors — typically larger creditors — to receive higher recoveries than others with the same priority claims in violation of Section 1123(a)(4) of the Bankruptcy Code, which requires that a plan provide the same treatment for each claim or interest of a particular class and Section 1129(b)(1) of the Bankruptcy Code, which prohibits unfair discrimination between similarly situated creditors.[4] Another common argument is that the payment of lucrative backstop fees in exchange for plan support violates Section 1129(a)(3) of the Bankruptcy Code, which requires a plan to be proposed in good faith and not by any means prohibited by law because the payment of backstop fees constitutes impermissible vote buying.[5]

The second common type of criticism focuses on the amount of compensation provided to the backstop parties and whether such compensation would be justified if the rights offering and backstop were subjected to market testing. A core argument made on this point is that backstop fees are not warranted and would be less substantial if the rights offering and backstop were subjected to a comprehensive market test from third-party financing sources. A related argument is that proceeding with a backstop of the rights offering and limiting the oversubscription rights of participants creates an artificial need for backstop parties, generates unnecessary costs for the estate and creates unmerited upside for the subset of parties permitted to participate in the backstop. Relatedly, parties that make these arguments also commonly note that there is typically limited visibility into how participation rights in a rights offering are distributed, which makes it difficult to accurately analyze the reasonableness or necessity of fees paid to backstop parties. To this point, lack of visibility is sometimes used to support arguments that backstop agreements approved in prior bankruptcy cases should not be used as a basis to approve a backstop agreement proposed by a debtor in a new bankruptcy case.[6]

Additional critiques of backstop agreements and rights offerings focus on the ability of only a portion of the debtor's creditors to participate.[7] For example, it is common for participation in a backstop agreement to be limited to entities that are U.S.-based companies or that qualify as accredited investors. This precludes many trade creditors and other non-financial parties from participating.

[4] *See infra* Trends in Backstop Agreements – Case Law.

[5] *See, e.g., In re Seadrill Limited*, The SVP Parties Objection to Debtors' Motion for Entry of an Order (I) Authorizing Entry into the Backstop Commitment Agreement, (II) Approving the Payment of Fees and Expenses Related Thereto, and (III) Granting Related Relief, (Bankr. S.D. Tex. Aug. 23, 2021) [Docket No. 864] ("The significant benefits afforded to the Backstop Creditors through the Backstop Letter compared to the de minimis risks the Backstop Creditors are incurring in connection with their purported Backstop commitments raise the specter of impermissible 'vote buying' through the provision of disproportionate benefits to the Backstop Creditors in exchange for their entry into the PSA and support of the resulting plan.")

[6] *See, e.g., In re SunEdison*, Objection of CNH Partners, LLC and AQR Capital Management, LLC to Debtors' Motion for Entry of an Order Authorizing and Approving (I)(A) Entry into the Backstop Commitment Letter, (b) Equity Commitment Agreement, (c) Payment of Fees and Expenses and (II) the Rights Offering Procedures and Related Forms, Case No. 16-10992 (Bankr. S.D.N.Y. May 16, 2017) [Docket No. 3133].

[7] *See, e.g., In re Gulfmark Offshore, Inc.*, Objection of Jeffrey L. Boyd & Magdalena L. Boyd to (I) Approving Rights Offering (II) Authorizing the Debtor to Conduct the Rights Offering in Connection with the Debtors Plan of Reorganization (III) Approving the Form of Materials Necessary for the Consummation of the Rights Offering (IV) Authorizing the Debtor to Assume the Backstop Commitment Agreement and Pay the Backstop Obligation and (V) Granting Related Relief and (VI) Disclosure Statement for Chapter 11 Plan of Reorganization of Gulfmark Offshore Inc., Case No. 17-11125 (Bankr. D. Del. June 14, 2017) [Docket No. 130] (arguing that debtor's proposed rights offering impermissibly took value from retail noteholders for the benefit of certain accredited investors).

Recent attention on backstop agreements, such as Judge Wiles's opinion in the *Pacific Drilling*,[8] have emphasized these concerns. However, objections of the type discussed previously and concerns like those raised by Judge Wiles have not prevented backstop agreements from continuing to be approved. Instead, objections, which are often used to generate leverage as opposed to true opposition to the terms of the backstop agreement, continue to be generally resolved by consensual resolutions rather than court decisions.

Trends in backstop agreements

Case law

As noted previously, bankruptcy court approval of backstop agreements is most commonly sought at the disclosure statement approval stage of a Chapter 11 bankruptcy case and, in some circumstances, the plan confirmation stage. As such, it is common for objections to be made not only to specific mechanics of the proposed backstop agreement, but also as support for an objection to the adequacy of the disclosure statement (i.e., objections that the disclosure statement contains inadequate information concerning the backstop) or to plan confirmation (i.e., aspects of the backstop render the plan non-confirmable). Although rare, as addressed next, courts have raised their own concerns over backstop agreements even where no objections to the backstop were filed.

This was the case in *In re Pacific Drilling S.A.* when the U.S. Bankruptcy Court for the Southern District of New York was presented with an uncontested motion to approve a backstop agreement. Despite no parties objecting to the terms, Judge Wiles initially refused to approve the backstop agreement citing his concerns that (i) the 8% backstop fee did not bear any relationship to the actual risk being undertaken by the proposed backstop parties, (ii) a $100 million private placement designated for the backstop parties was a disguised over-allocation of rights for these creditors and (iii) the backstop fees, which were to be paid in kind with deeply discounted securities, provided the backstop parties with an impermissible windfall. In a bench ruling dated October 1, 2018, however, Judge Wiles ultimately approved the debtors' proposed rights offering, on a slightly modified basis over his own reservations while further articulating his concerns with backstop agreements.[9] The decision generated some concern that it would be more difficult to obtain court approval of backstop agreements in future cases.

These concerns were, at least in part, obviated following the U.S. Court of Appeals for the Eighth Circuit's decision *In re Peabody Energy Corp.*,[10] in which the appellate court approved the debtors' entry into the backstop agreement notwithstanding creditor objections and held that the debtors' Chapter 11 plan complied with Section 1123(a)(4) of the Bankruptcy Code, which requires the same treatment for each claim or interest of a particular class, despite providing more favorable treatment to creditors that agreed to backstop the debtors' rights offering by paying the participating creditors a significant premium and allowing them to purchase preferred stock in the reorganized debtors at a deep discount. In so ruling, the Eighth Circuit placed significant emphasis on the risk undertaken by the backstop parties as a justification for their significant compensation. Since the *Peabody* decision, numerous backstop agreements have been approved with no significant court decisions reported.

A separate issue related to backstop agreements was addressed in a decision from the *In re MPM Silicones, LLC* bankruptcy case, in which the bankruptcy court addressed an objection to a proposed backstop agreement.[11] Specifically, the objecting parties argued that the payment

[8] *In re Pacific Drilling S.A.*, Bench Decision Regarding Motion for Approval of Terms of Equity Rights Offering and Equity Commitment Agreement, Case No. 17-13193 (Bankr. Ct. S.D.N.Y. Oct. 1, 2018) [Docket No. 631].

[9] *Id.*

[10] 933 F.3d 918 (8th Cir. 2019).

[11] *See In re MPM Silicones, LLC*, 518 B.R. 740 (Bankr. S.D.N.Y. 2014).

TABLE 1. Overview of key cases involving backstops

Case	Initial Rights Offering Amount	Instrument Being Backstopped	Discount to Plan Value (%)	Backstop Fee (%)	Payment Method	Backstop Party/Parties
24 Hour Fitness (2020)	$65 million	Preferred Equity	N/A	10	In Kind	Ad Hoc Group of Term Loan Lenders and Unsecured Noteholders
American Commercial Lines Inc. (2020)	$150 million	Preferred Equity	N/A	7	In Kind	Term Loan Lenders
Berry Petroleum (2016)	$335 million	Preferred Equity	N/A	7	In Kind	Unsecured Noteholders
Breitburn Energy Partners LP (2016)	$775 million	Common Equity	N/A	10	In Kind	Unsecured Noteholders
California Resources Corporation (2020)	$450 million	Common Equity	35	10	In Kind	Term Loan Lenders
CHC Group (2016)	$300 million	Second-Lien Convertible Notes	10	10.3	In Kind	Plan Sponsors and Unsecured Noteholders
Diamond Offshore Drilling (2020)	$125 million	First-Lien Notes	N/A	9	In Kind	Senior Noteholders
EP Energy Corporation (2019)	$475 million ($325 million of newly issued shares and $150 million in debt converted to equity)	Common Equity	25.7 (with respect to converted debt) and 35% (for newly purchased Common Equity)	8	In Kind	First-Lien Noteholders
Erickson Inc. (2016)	$20 million	Common Equity	10.0	6	In Kind	Second-Lien Lenders
Fieldwood Energy LLC (2020)	$20 million	Common Equity	N/A	8	In Kind	First- and Second-Lien Term Loan Lenders

(*Continued*)

TABLE 1. Overview of key cases involving backstops (*Continued*)

Case	Initial Rights Offering Amount	Instrument Being Backstopped	Discount to Plan Value (%)	Backstop Fee (%)	Payment Method	Backstop Party/Parties
Garrett Motion Inc. (2020)	$632 million	Series A Preferred Equity	N/A	8.44	In Kind	Plan Support Parties/Investors
Hertz (2020)	$1.635 billion	Common Equity	N/A	10	In Kind	Plan Sponsor
Linn Energy Inc. (2016)	$530 million	Common Equity	20.0	4	Cash	Secured and Unsecured Noteholders
Lyondell (2009)	$2.8 billion	Class B Equity	39.8	2.5	In Kind	Plan Sponsor
Peabody Energy (2016)	$750 million	Common Equity	45.0	8	In Kind	Second-Lien Noteholders and accredited holders of allowed general unsecured claims
Seadrill (2021)	$350 million	First-Lien Notes	N/A	10.9	Cash/In Kind	First-Lien Credit Agreement Claimants
SunEdison, Inc. (2017)	$300 million	Common Equity	2.4	7	In Kind	Second-Lien Creditors and General Unsecured Creditors
The Gymboree Corporation (2017)	$80 million	Common Equity	35.0	5	In Kind	First-Lien Term Loan Lenders
Ultra Petroleum Corp. (2020)	$42.5 million	Common Equity	N/A	7.5	In Kind	Consenting Lenders Under RSA
Washington Prime (2021)	$325 million	Common Equity	32.5	9	Cash	Ad Hoc Bank Group holding corporate-level bank debt
Windstream Holdings Inc. (2019)	$750 million	Common Equity	37.5	8	In Kind	Certain holders of First-Lien, Second-Lien and unsecured debt and an Ad Hoc Group of other 1L Lenders

subordination provisions in their intercreditor agreement with certain junior creditors (who were backstop parties) restricted those junior creditors from receiving payments under the backstop agreement. The bankruptcy court concluded that payments made to the junior creditors pursuant to the backstop agreement did not violate the subordination provisions of the parties' intercreditor agreement and the backstop creditors were permitted to keep the backstop fees they received from the debtor[12]. The bankruptcy court reasoned that although the cash to be paid to the junior creditors "could be viewed as Common Collateral. . . the payment . . ., if made, [would] be based on the [junior creditors'] rights under the Backstop Agreement, not in respect of remedies as secured creditors. Such payment would not be on account of a secured obligation or the junior and secured creditors' mutual collateral but, rather, a separate, unsecured obligation undertaken by the debtors to the defendants for backstopping new exit financing for the debtors beyond the time provided in the Backstop Agreement."[13] Thus, creditors that are parties to a backstop agreement may, under certain circumstances, be able to receive payments on account of their participation in a backstop so long as the receipt of such payments is not proscribed by the specific terms of their intercreditor agreement.

Overview of key cases involving backstops

The rights offerings and backstop fees for several large cases are summarized in Table 1 herein.

Key terms

Compensation & commitment period

Backstop agreements are heavily negotiated, and certain provisions are often highly situation dependent. Compensation or the fees to be provided to the backstop parties is, perhaps, the most heavily negotiated provision in backstop agreements. In the cases surveyed in Table 1, backstop fees ranged from 2.5% in *Lyondell* to 10.9% in *Seadrill*, with fees typically paid in kind or with a combination of cash and securities. As shown in the table, the amount of backstop fees paid does not necessarily rise proportionately with the amount of the initial rights offering being backstopped. The *Lyondell* case demonstrates this, as the backstop parties were paid a 2.5% backstop fee despite the initial rights offering involving the issuance of $2.8 billion in Class B Equity. Backstop commitment periods vary significantly and can be difficult to predict, running between 27 and 261 days of cases surveyed. There are no clear trends over the last approximately ten years or in more recent cases on this point.

In more recent cases from the last two years backstop fees appear to have commonly been between 7% and 10%, with a slight preference in favor of higher backstop fees. For example, *California Resources Corporation* involved a 10% backstop fee payable in equity of the reorganized debtor at the same per share price as the rights offering (i.e., at a 35% discount to the $1.65 billion plan equity value). The *24 Hour Fitness* case involved a 6% backstop fee paid in-kind along with a 4% upfront equity investment right payable in reorganized common equity issued through the debtors' plan to the debtor-in-possession lenders that backstopped the debtors' rights offering. In the *Washington Prime* case, the backstop parties were paid a 9% backstop fee on the $325 million rights offering paid in kind with common shares priced at a 32.5% discount to plan equity value. Finally, in Seadrill's 2021 bankruptcy case, the backstop parties' fees were comprised of a cash payment of $20 million (equal to approximately 6.67% of the total rights offering) and 4.25% of the equity in the reorganized debtor issued under the rights offering.

Other key provisions

While backstop fees are typically highly negotiated, backstop agreements also contain a number of core provisions that are largely consistent between backstop agreements.

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[12] *Id.* at 753.

[13] *Id.*

— **Plan voting:** One common provision is a requirement that the backstop parties support the debtor's plan by voting in favor of it. On this point, it is not uncommon for backstop parties to also be parties to a Plan Support Agreement ("PSA") or Restructuring Support Agreement ("RSA") requiring them to support and vote in favor of the debtor's plan.

— **Expense reimbursement:** Backstop parties typically negotiate for and receive the right to be reimbursed in cash for their reasonable and documented costs and expenses incurred in connection with negotiating and entering into the backstop agreement. Reimbursement rights may be subject to agreed caps, but under certain circumstances and based on the parties' negotiations, backstop parties may be able to obtain an uncapped reimbursement right.

— **Conditions precedent to backstop party's obligations:** There are a number of customary conditions to the backstop parties' becoming obligated to fulfill their obligations under the backstop agreement, including (a) the occurrence of specified events in the bankruptcy case (such as confirmation of the debtor's plan and other milestones intended to move the case forward), (b) the confirmation order becoming final and non-appealable, (c) the occurrence of the plan's effective date, (d) receipt of an agreed form of funding notice and (e) the representations and warranties in the backstop agreements remaining true and correct. In addition to such customary conditions, the debtor and the backstop parties may negotiate and include in the backstop agreement additional, situation-specific conditions to the backstop parties' obligation to perform under the backstop agreement.

— **Transfer of backstop rights:** Backstop agreements commonly limit the transfer of backstop rights (and the backstop parties' other claims or equity against the debtor) to specifically defined parties, most commonly other backstop parties or parties who otherwise agree to be bound by the backstop agreement and any operative RSA or PSA.

Conclusion

Rights offerings have proven to be an increasingly common method by which debtors raise necessary capital to emerge from bankruptcy. In connection with rights offerings, backstop agreements have similarly proven to be critical to building consensus and guaranteeing that debtors are, in fact, able to raise necessary capital in order to achieve plan confirmation and emerge from bankruptcy. Although backstop agreements have faced certain criticisms, the Eighth Circuit's decision in *Peabody Energy* suggests that, at a minimum, backstop agreements remain a very viable tool for debtors to employ in connection with raising capital to exit bankruptcy.

13.I START YOUR AUCTIONS: STALKING HORSE BIDDING AND OTHER CONSIDERATIONS FOR DRIVING VALUE IN THE CHAPTER 11 SALE PROCESS

LEGAL PERSPECTIVE

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Your company is distressed. The secured lenders are expressing concerns regarding their loans being repaid and the board is looking to maximize value for the company's stakeholders — what now? An "out-of-court" sale of the company's equity or assets to a potential buyer might work, but all of the potential buyers are expressing concerns about potential liabilities they might assume and risks associated with any transfer of the business or its assets in an out-of-court process. In fact, many of the potential buyers are insisting on an "in-court" or bankruptcy court supervised sale process to ensure that the assets and business they acquire are "free and clear" of unwanted liabilities and risks. The board might consider an in-court process but doesn't want the company to commence bankruptcy without a deal in hand. So, the board's strong preference is to find a buyer to serve as the "stalking horse bidder" who has agreed to submit a binding bid that sets a floor as to price, has limited conditions to closing and all but guarantees that the distressed company will have at least one deal to close at a value at an acceptable price. This chapter is written to guide you through the in-court process, focusing on why "stalking horse" bid protections might help the board obtain a deal that actually maximizes value for the company's stakeholders.

What protections does the bankruptcy code provide distressed companies and potential buyers?

Understandably, most companies want to complete a restructuring (including a restructuring through a sale) in an out-of-court process. The primary advantages of an out-of-court sale process are that it often involves lower costs, may require less time to consummate and frequently allows the selling company to better control the public dissemination of information and potential litigation. Notwithstanding these benefits, there are occasions when a buyer will simply insist on using an in-court process to consummate a transaction. If properly planned and executed, an in-court sale of the distressed company's assets and business may actually result in the company's stakeholders receiving a higher price or greater value despite the additional expense an in-court sales process might entail. In particular, a distressed company contemplating an out-of-court sale may face significant hurdles in consummating a sale because of governing credit documents (e.g., companies may be prohibited from selling assets until a debt is repaid in full) or because the potential buyer wants to avoid the actual and perceived risks associated with successor liability or subsequent challenges by creditors regarding the fairness of the price paid or the sale process being conducted. In such out-of-court situations, the distressed company will receive a lower value or purchase price for its assets. An in-court process using the Bankruptcy Code gives both distressed sellers an avenue for the board to obtain great value while giving the buyer of a distressed company greater legal protections.

The provisions of the Bankruptcy Code permit a distressed company, as a debtor in possession, to sell its business and assets in parts (e.g., a business line or a fleet of vehicles) or as a whole ("free and clear" of many of its actual and potential liabilities) and to do so pursuant to a bankruptcy court order that protects the buyer from subsequent challenges, including to the sales process, to the price paid and to claims asserted against the assets the buyer acquired. Although sales may be consummated pursuant to a plan of reorganization, most buyers seek to purchase a distressed company's assets pursuant to section 363 of the Bankruptcy Code. Section 363 of the Bankruptcy Code permits a debtor to sell its assets in a shorter and less costly process compared to a plan. A sale of assets pursuant to a plan of reorganization also requires a debtor to satisfy the Bankruptcy Code's disclosure and plan confirmation requirements that often have nothing to do with an asset sale and burden the debtor with costs that buyers are unwilling to cover. As a result, buyers are often far more interested in a section 363 sale process to achieve the goals of acquiring assets while shedding the debtor's burdensome obligations, either by excluding liabilities from the acquisition or by having the debtor "reject" burdensome executory contracts or leases.

When does a stalking horse maximize value for the company's stakeholders?

The term "stalking horse" initially referred to a horse or horse-like figure that hunters used to mask their presence, stalk animals and prevent prey from immediately fleeing. Over time, the term stalking horse has broadened to include other situations for when a party (i.e., the hunter) leverages another party (i.e., the stalking horse) to provide value. In the context of sale transactions, the term is now used to describe a party that submits a bid that sets a floor for the value of a company or its assets but permits itself to be subject to an auction in which higher or otherwise better bids are solicited.

Over the past three years, in a true testament to the value of a stalking horse bid, stalking horse bidders in large and complex Chapter 11 cases have become routine. Ropes & Gray reviewed over 100 large Chapter 11 cases (i.e., cases involving over $100 million of assets) involving 363 sales during such period, and the conclusions are not surprising:

— Approximately 65% of the cases involving a sale had a stalking horse bidder.

— Of the cases that involved a stalking horse bidder, an overbid above the stalking horse bid was submitted approximately 88.9% of the time.

— The stalking horse bidder won in a majority of the auctions, winning approximately 54.2% of the time.

Thus, most in-court sale processes involve stalking horse bidders, and in the majority of those instances the stalking horse bidder ultimately prevails in the auction either because no other bidder appears or because the stalking horse bids again and wins.

So why should a board pursue a stalking horse bid for an in-court sale process? As an initial matter, the mere existence of a stalking horse bid signals to other potential bidders, the company's creditors and the bankruptcy court that the company has at least the value set forth in the stalking horse bid.

Properly structured, the stalking horse bidder will be required to close at the price offered because the stalking horse bidder should not have any diligence or financing conditions to closing.

Moreover, having a stalking horse bid sets a floor and provides a time period for other interested bidders to investigate the assets for sale and determine whether to submit a higher or otherwise better bid. So, by entering into an agreement with a stalking horse bidder, the company may actually receive even greater value from higher bids submitted at an auction, and, as already noted, approximately 88.9% of the time other bidders actually submit higher bids resulting in an auction of the company's assets. And critically, if an auction occurs, the company may be able to successfully play bidders against each other to further increase and ultimately maximize value for stakeholders.

Additionally, in the auction setting, the company may pick and choose, subject ultimately to court approval, the form of additional consideration it prefers. Although cash may be king, sometimes bidders don't want to (or can't) put up cash and will instead assume a company's liabilities, which may be just as valuable to a company. This assumption may take the form of agreeing to pay the company's contracts with large upcoming future payments. Alternatively, bidders may assume liabilities immediately through (i) agreeing to assume contracts or leases with large cure amounts (i.e., amounts outstanding that must be paid before assumption and assignment), (ii) making priority payments such as on account of a tax or environmental liability, (iii) agreeing to acquire the entirety of the company's business and its attendant obligations rather than just the "crown jewel" assets, or (iv) making payments on account of general unsecured claims, which in certain instances may be given only partial credit on the theory that such claims would not have been paid in full anyway. Incremental value may also take the form of agreeing to assume a contingent or disputed liability, the value of which may be difficult to ascertain at the time of sale.

The assumption of employee liabilities is yet another way that a stalking horse bidder may provide value. If your company is being sold as a going concern, it may be the case that the buyer will offer employment to some or all of your employees. Besides the obvious social benefits to hiring employees, a buyer taking on employees can reduce associated "priority" claims for a debtor, thereby having a direct financial benefit to the estate. In particular, employees are entitled to priority treatment of their wages, benefits and salaries up to a cap and a buyers' assumption would reduce that pool.

Bidding protections: necessary, expected and value maximizing

Unfortunately, because of the risk of being overbid and the time and expense associated with conducting diligence on a distressed company, distressed sellers are rarely able to obtain a stalking horse bid for free and sophisticated buyers know this. Stalking horse bidders have thus come to request and expect numerous types of stalking horse "bid protections" to compensate them for the time, expense and opportunity cost of making a stalking horse bid and the risk of being overbid at an auction.

Since its introduction into the bankruptcy world in 1989, the most significant request made by a stalking horse bidder is a request for a "break-up" fee. A break-up fee is a fee to incentivize the potential bidder to serve as a stalking horse that sets the floor price, that agrees to the assets being marketed and that takes the risk that it is either overbid at an auction or the company chooses not to sell its assets and as a result, the stalking horse bidder does not actually close on the asset sale through no fault of its own. Typically, the break-up fee is set at some percentage (often about 2% to 3%) of the purchase price the bidder is offering to pay for the purchased assets.

Break-up fees provide value to the distressed seller because without them, most buyers would not be willing to set a floor and allow their bid to be shopped publicly and for any extended period of time. During the in-court sale process, any sale outside the ordinary course of business must be approved by the court and a company simply cannot close a sale without such court approval. Because the court approves a sale, it must look at the sale process and assess whether the company truly sought to maximize value for its stakeholders. And when a company is seeking to obtain the highest or otherwise best bid, it wants to offer potential bidders a break-up fee to incentivize a bidder to serve as the stalking horse in that auction process. Such break-up fee may be contested on the basis that a break-up fee can chill bidding — notwithstanding the fact that a break-up fee is usually exactly the type of incentive necessary to induce a stalking horse bidder to submit a bid.

The two biggest non-economic issues on which a stalking horse bidder negotiates are (i) the conditions under which the break-up fee will be paid and (ii) what assets are available to pay it. A debtor usually prefers for the fee to be paid only if and when an alternative transaction is consummated that is determined by the debtor to be higher or better. At that time, the debtor will know it has an alternative it prefers and sufficient funds to pay the break-up fee. On the other hand, a stalking horse bidder will typically prefer that the fee (i) be immediately payable upon the acceptance of a higher or otherwise better offer, (ii) constitute an administrative expense claim — that is, a claim required under the Bankruptcy Code to be paid in full before the company can emerge from bankruptcy and (iii) be subject to bankruptcy court approval to ensure the aforementioned protections are properly in place. Some stalking horse bidders even ask for break-up fees to be paid as an administrative expense even if the stalking horse deal does not close because of circumstances not within its control.

Predicting whether a particular break-up fee will be approved by a bankruptcy court is more art than science, but the issues courts generally consider are: (i) is the break-up fee within the percentage that has generally been approved before, and if not are there extenuating circumstances, (ii) are there other bidders that are prepared to serve as a stalking horse without a break-up fee or with a smaller break-up fee and (iii) will the size of the break-up fee chill bidding. Too large and the break-up fee may chill bidding because bidders usually have to submit a competing bid that not only covers the break-up fee, but also provides some additional value to the debtor. Courts have found break-up fees totaling 2% to 3% of the purchase price to be "reasonable", with the recent trend of 3% of the purchase price being a new standard.

Other benefits of bid protections

In addition to the economic carrots that a distressed company may offer to a potential stalking horse bidder, there are a number of protections that stalking horse bidders frequently request because of the intangible benefits they provide. Stalking horse bidders often drive the form of the baseline documents associated with a sale and, thus, have significant influence on how a potential sale is structured. So, frequently a stalking horse bidder requests that all subsequent bidders use their structure and agreement. Additionally, stalking horse bidders can weigh in on various issues that can affect bidding, such as the form an acceptable overbid must take, the size and type (e.g., cash or credit bid) of the deposit other bidders must submit, the initial overbid amounts (how high the second bid has to be to beat the stalking horse bid), minimum bid increments (the amount that each additional bid must be to constitute a valid bid), the timeline for an auction and sale and what counts as "value" for bidding purposes (e.g., whether assuming certain liabilities will count as value for the bid). A combination of these protections plainly benefits the stalking horse bidder but may not benefit the company. For example, setting a baseline initial overbid amount that covers the break-up fee and anticipated expense reimbursement or otherwise requires payment of such fee from the winning bidder ensures the company will not wind up with a worse deal after paying the stalking horse bidder's break-up fee and expense reimbursement, but setting too large of an overbid or too short of an auction and sale timeline may decrease the likelihood that the company will obtain the highest or otherwise best value for the assets being sold.

Section 363 sales and stalking horse bidder takeaways

Given the number of potential incentives and the unique circumstances of each company, negotiations with a potential stalking horse bidder can become quite complicated and take on a life of its own. In the next section, however, are a few guiding principles to guide a distressed company when trying to get more value for the company in connection with a potential sale:

— **Pick a stalking horse:** At the end of the day, having a stalking horse bidder is better than starting a "naked" sale process with no bidder at all, which may be different than a healthy M&A process. In a non-bankruptcy M&A process, a company can go back to the drawing board if a sale doesn't close; a distressed company normally does not have the liquidity to start again. If a distressed company does not set a floor, then the board may find itself in a situation where bidders are all bidding below the value of the company, or worse, receiving no bids at all because the company doesn't have the resources to fully shop the assets.

— **Keep the fees reasonable:** Although companies should be incentivized to keep fees low to obtain a higher return for stakeholders, companies should pay reasonable break-up fees to incentivize bidders to serve as a stalking horse, but not too high to chill bidding. In the in-court process this decision is public, so a debtor needs to be prepared to defend the reasonableness of the fees to the United States Trustee (a government "watchdog", part of the Department of Justice), the official committee of unsecured creditors (a formal group of creditors whose job is to maximize value for unsecured creditors) and of course, the bankruptcy court itself.

— **It's not always about the money:** Although break-up fees and expense reimbursements are common for stalking horse bidders, the true value of a bid and the board's willingness to commit to a break-up fee and expense reimbursement should not be solely based on cash purchase price. Depending on the company and the circumstances, sometimes other aspects of a bid are just as valuable to the board. For example, the board should also consider a bidder's intentions regarding retaining employees or continuing the company as a going concern in assessing the value of a bid and the protections to afford that bidder as incentives for serving as a stalking horse.

13.II START YOUR AUCTIONS: STALKING HORSE BIDDING AND OTHER CONSIDERATIONS FOR DRIVING VALUE IN THE CHAPTER 11 SALE PROCESS

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A successful sale transaction fundamentally depends on the coming together of a buyer and seller, and is judged based on price, speed and certainty. Distressed sales are no different, but typically involve several issues not generally considered in "healthy" transactions. For example, a sale through Chapter 11 adds complications including the possibility of business disruptions, the perceived stigma that some may attach to the bankruptcy process and increased cost. While a distressed sale can be consummated out-of-court, buyers may prefer to use the bankruptcy code to ensure the sale is "free and clear" of legacy costs and obligations. For the seller, this may have the added benefit of enhancing the value proposition due to contracts that can be rejected in bankruptcy.

Special consideration must be given to certain parties outside the typical healthy sale process, including creditor groups and the bankruptcy code. Once a company files for protection under Chapter 11, the decision to sell shifts from a two-dimensional chess game, involving the buyer and seller, to a four-dimensional game, incorporating the views of creditors and the bankruptcy court. While parties involved in an in-court sale will support the objective of "maximizing value," their individual views may differ on what those values should be and how they will be best realized. Differences will depend on the parties' positions in the hierarchy of priority and how their rights have been protected by various legal documents, contracts and agreements. In the end, the court will be the final arbiter mediating the common and conflicting objectives of the constituencies involved, including approving a winning bidder via a formal sale process and auction.

Paths to a sale

A company has three general paths to selling itself as a going-concern in Chapter 11 (See Table 2)—pursuant to a sale (typically a public auction) under Section §363(b) of the Bankruptcy Code, pursuant to a plan of reorganization or through a built-in toggle from a Chapter 11 plan to a §363 sale.

TABLE 2. In-court sale paths

	§363 Sale	Chapter 11 Plan Sale	Sale Toggle
Overview	— Sale of business pursuant to a court-supervised process — Sale price must reflect the "highest or best offer" and thus an auction is typically held	— Sale of business pursuant to a plan of reorganization — Reorganized entity is formed with controlling equity going to buyer and capital structure is reset	— A plan of reorganization is pursued with the ability to toggle to a §363 sale based on certain parameters agreed upon between the debtors and plan sponsor
Benefits	— Generally, faster process than a plan of reorganization; subject only to court approval, not plan voting and confirmation process	— Broader flexibility in structuring the acquisition and financing — Provides finality to the case and potential for releases to parties, especially for private companies	— Dual path may provide greater certainty that a value maximizing path was pursued — Results of sale process may facilitate consensus among those opposing plan — Provides certainty of an exit with key parties (e.g., customers, suppliers)
Considerations	— Public process — Bid protections for stalking horse bidder are customary — Pre-petition marketing process may impact timeline	— Generally, more time consuming, complex and costly vs. §363 sale	— Bidders need to be sufficiently convinced to participate given the uncertainty of consummating a third-party sale

An in-court sale through an auction process is the most common path pursued given, among other reasons, the relative speed to close and the less burdensome legal test to approve a sale. A sale through a plan of reorganization brings about the complexities and hurdles in obtaining approval of a plan and is more often pursued in cases where there are material structuring benefits unique to the buyer. For example, a sale of the debtors' equity may result in the exemption from certain taxes, the potential to preserve valuable tax attributes, avoidance of intellectual property issues or the streamlining of regulatory approvals. A plan sale may also provide more flexibility in how a sale is financed, including the potential ability to have pre-petition creditors roll their claims into debt of the reorganized entity.

The sale toggle path has become more prevalent in recent years given the ability to provide key constituents greater assurances that the highest value was realized for the assets. While a plan sponsor (often some mix of pre-petition creditors), may generally support a plan of reorganization as new owners of the reorganized company, the uncertainty of achieving clear economic payoffs from executing the business plan may make the prospect of an alternate sale path providing a higher and more certain value an appealing one.

Running a §363 sale process in parallel to a plan of reorganization likely encourages only serious bidders with the intent of bidding above the plan value to deploy resources towards the diligence process. However, given the risk of the debtors and supporting creditors ultimately pursuing a plan, bidders may need to be sufficiently incentivized to participate in the process. This may include the ability to bid as a stalking horse bidder with its associated benefits and/or having secured creditors agree to a reserve price (i.e., if a qualified bid exceeds the reserve price, the secured creditors would agree to support a sale).

The ability to conduct a sale process in parallel to a plan may serve as a "market test" to validate with key constituents, including the debtors' board of directors, that a plan of reorganization is the value-maximizing path. The results of a well-constructed §363 sale process can also streamline the plan process as evidence to defend against stakeholders objecting to the plan based on valuation, risking both delays and additional costs.

Driving value in a §363 sale process

Given a §363 process is the most common path pursued to sell a business in-court as a going concern, the remainder of this chapter will focus on structuring and optimizing this sale process to drive value and provide confidence to the board that a value-maximizing process was effectuated.

Funding the sale process

Ideally, the company can organically fund both the pre- and post-petition runway necessary to execute on a distressed sale. However, in many distressed situations, liquidity is limited and new financing, most often coming in the form of debtor-in-possession ("DIP") financing, will play a key role in the sale process timeline. The DIP financing should provide for the ability to conduct a process consistent with what debtors and their advisors believe will maximize value. Proceeds should be used to sufficiently address all costs necessary to preserve the value of the marketed assets (i.e., payments for employee retention, working capital, critical maintenance capital expenditures and a range of other costs). Failure to do so may raise concerns that the business is at risk of deteriorating and could result in prospective buyers deducting value to their bids disproportionately more so than the costs to address such issues.

The breadth of the outreach and length of the process may be informed, or influenced, by any pre-petition marketing effort, among other factors. A broad outreach should allow buyers sufficient time to conduct proper diligence, submit a qualified bid, participate in an organized auction and close on a sale. In a process where strategic buyers are likely interested, the timeline and milestones should be accommodative, given their ability to at times pay more than financial buyers due to the prospects of realizing synergies. Some strategics may need additional time to run through their internal processes towards formulating a comprehensive bid.

Support from key secured creditors

From the outset, understanding the motivations of key creditors will be critical to navigating the process. Aside from likely requiring consent from secured creditors to approve a final sale, their commitment to support the pursuit of a sale process, particularly if value could "break" inside of their allowed claims, will be important to encouraging bidders to put forth the time and resources toward constructing competitive bids. If prospective bidders believe there is a high likelihood that secured creditors will ultimately "credit bid" for the assets, and thus in effect set a reserve price, the sale process will be at an elevated risk of losing the competitive tension needed to drive the process towards a value-maximizing outcome. A credit bid is when a secured creditor bids up to the entire face value of its claim, generally including any unsecured deficiency portion, for the assets. The ability to bid the deficiency portion in situations where even the most optimistic buyers believe that fair value is less than the full amount of the secured claims risks "chilling" the process.

Securing a stalking horse bidder

The marketing process is often launched before filing for Chapter 11 with the goal of securing an executed stalking horse asset purchase agreement by the petition date. A "stalking horse" bidder refers to a party to whom the debtor agrees to sell assets through a binding purchase agreement, subject to higher or better offers in a court supervised auction. Securing an initial committed bid at the outset of filing provides the benefit of upfront certainty of an acceptable bid for key stakeholders by setting a floor price for the auction and avoids the dynamic of receiving a set of bargain-basement bids at the conclusion of the auction. The stalking horse bid encourages serious parties to work towards a higher bid to qualify for the auction. It also benefits the debtors greatly by making it easier to secure DIP financing, essentially acting as a bridge to consummate a sale.

In exchange for the costs and risks associated with providing this early binding commitment, a stalking horse bidder often receives certain benefits such as a break-up fee and/or expense reimbursement, subject to court approval. A break-up fee is paid to the stalking horse in certain circumstances, most commonly if an alternative transaction is pursued.

A stalking horse bidder will often receive other benefits, most notably, the ability to negotiate key elements of the bid procedures, including:

— Setting certain filing, bid and other key process deadlines;

— Screening thresholds to determine a qualified bidder (e.g., documents to determine financial wherewithal, required cash deposits);

— The requirement for bidders to bid on terms and structure similar to the stalking horse bid;

— The ability to review submitted bids ahead of the auction;

— The auction format, including overbid protections such as setting the initial overbid amount and minimum bid increments.

Subject to the circumstances of each case, less common bid protections may also be approved. For example, the bid procedures may allow the stalking horse bidder to solicit consent from customers to the proposed sale, even though the bid would still be subject to higher or better offers. The justification here may be that without providing assurances to customers and absent an alternate bidder, value could be negatively impacted.

Outreach

If the goal is to secure a stalking horse bidder by the petition date, outreach will begin prior to filing and care must be taken in determining both which parties to include (i.e., risk of sharing competitively sensitive information) and the breadth of the outreach (i.e., risk of informational leaks that may cause detriment to the business). This becomes even more important in the case of marketing a public company. There is a delicate balance as competitors can often submit the most competitive bids, but their inclusion may also result in the need to share sensitive information. One way to address such concerns is through a “clean room” mechanism whereby such information is shared on a limited basis with certain buyers and/or their advisors.

Confidentiality agreements are meant to protect against such risks and should also mitigate the risks of interlopers who could be detrimental to the process. For example, debtors should consider the process risks and implications of potential buyers communicating directly with creditors. While it is understandable for buyers to seek clarity on a “reserve price” of key creditors, such communication is generally prohibited under confidentiality agreements. Confidentiality agreements also often include a standstill from purchasing debt as the ability to do so may result in a prospective buyer obtaining influence in a debtor’s plan of reorganization or the ability to use the claims as currency in an acquisition.

Once a company files for Chapter 11, the sale process will gain more publicity due to news publication of the event. Nevertheless, §363 sales may involve less competition than regular way sales processes as certain prospective investors may not have the level of comfort and understanding of the bankruptcy process, and thus may be less willing to participate. Given this dynamic, the debtors’ advisors often encourage tentative investors to engage advisors that have the appropriate experience in distressed in-court asset sale processes.

Bid procedures

The bid procedures lay out the timeline, requirements for submitting a qualified bid, and guidelines for bidding in the auction, among other items. The various components of the bid procedures are important to construct properly because they may have a material impact to the overall competitive dynamics (see Table 3). For example, a requirement may be set for the winning bidder to increase the cash deposit to mitigate the risk of such bidder subsequently withdrawing from the process. The bid procedures will also outline the parameters of a "back-up bidder" who would be responsible to close on the transaction as the next highest bidder in the auction, providing the debtors, key stakeholders and the court with additional certainty if the winning bidder does not close.

The secured creditors, stalking horse bidder, unsecured creditor committee and DIP lenders will all have the opportunity to try and influence the provisions in the bid procedures, some of which may conflict with the company's view of what would support a value-maximizing process. The bid procedures will also be under scrutiny by the court and other stakeholders who will assess whether the proposed procedures provide the stalking horse with protections that risk chilling the sale process.

Auction

Ahead of an auction, qualified bids are submitted by the prospective buyers and reviewed by the debtors and selected constituencies, often referred to as the "consultation parties." The form(s) of consideration and certainty of close will be two critical elements, among others, in analyzing the submitted bids. Cash is generally the preferred form of consideration for secured creditors. Cash is also needed to pay administrative and priority claims to exit Chapter 11 and to cover the cure costs for a buyer to assume contracts in default. Analyzing bids can be complicated on a like-for-like manner when other forms of consideration are introduced (i.e., debt, deferred payments, contingent payments, equity, the relinquishment of claims against the seller and/or the assumption of liabilities, among others). The debtors and their advisors determine, and often review with the consultation parties, whether the noncash consideration should have the same dollar-for-dollar value as cash.

Closing

If the winning bidder and back-up bidder in the auction cannot close within the allotted period, the estate would be burdened with the additional costs of remaining in-court for longer than expected. There would be no guarantees that other bidders who had

TABLE 3. Key bid procedure elements

Auction	Timing	Certainty to Close	Price
— The ability to bid for discrete assets via multiple auctions vs. the entire company	— Initial indication of interest deadline — Qualified bid deadline — Timeline to close	— Qualified bidder requirements, including: — Evidence of financial ability — Good-faith deposit — Reps and warranties — Financing and other contingencies — Fiduciary out to modify procedures — Back-up bidder parameters	— Initial overbid and minimum increments — Acceptable forms of consideration and how bids will be judged (e.g., the amount of net cash to the estate, value of noncash currency)

been proactive in the process will bid the same levels as submitted in their qualified bid or the auction. However, this risk can be mitigated through properly constructed bid procedures that establish financial wherewithal requirements and limit post-auction contingencies.

Antitrust approvals may delay closing materially and planning should be done as early as possible, well ahead of any auction. For example, under the Hart–Scott–Rodino Antitrust Improvements Act ("HSR"), parties must file pre-merger notification with the Department of Justice and Federal Trade Commission and wait for the government agencies to review. There is an initial 15-day HSR waiting period in a bankruptcy that agencies use to assess if a more in-depth second request is required. A "pull and refile" process may provide another 15-days for the agencies to make the assessment. If there is a second request, the time to complete could take months after the initial waiting period and thus materially delay a sale closing. Parties who may be at risk should file with the agencies as early as possible with the goal of receiving clearance by or soon after the auction.

Conclusion

An in-court sale process involves advancing multiple priorities in parallel, including navigating a complex landscape of stakeholders, court proceedings and milestones. While certain factors, such as market conditions, may be outside of a company's control, there are strategic measures that can increase the likelihood of a robust and competitive sale process. Carefully establishing a forward-thinking game plan, mapping out all possible scenarios and forging productive alliances with key stakeholders are critical first steps. Given that the bankruptcy process is multidimensional, such steps may not obviate the need to quickly recalibrate tactics to ensure the process remains well-positioned.

With the table stakes high and timeline often compressed, effectuating a properly run in-court sale process can be resource intensive, testing the resolve of all those involved. However, through a baseline understanding of the process and constituent dynamics, the board, with the assistance of senior management and the company's advisors, can confidently navigate the complexities to achieve a value-maximizing endgame.

14 EXIT FINANCING OPPORTUNITIES AND STRATEGIES

LEGAL PERSPECTIVE

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The goal of a Chapter 11 case is to confirm a plan. While plans can come in various shapes and sizes, including involving the sale of the business or the liquidation of the debtor, the pinnacle of achievement in Chapter 11 is confirming a plan of reorganization that leads to the debtor emerging from bankruptcy leaner and meaner and ready to operate its business post-emergence in fulfilling and enriching ways. Achieving such a result requires a lot of things to go right. The debtor has to withstand the initial shock and chaos that often accompanies a bankruptcy filing, navigate the rules and requirements of a debtor in bankruptcy, pay the administrative burden of a case, structure a plan that creditors and, perhaps, equity interest holders approve and are willing to vote on and procure from the court an order confirming that the plan does not get stayed or appealed. Assuming the debtor can do all of those things and more, the debtor is set to emerge from bankruptcy in an orderly, structured and agreeable way. The linchpin to all of that, though, is of course, money. The debtor needs money to fund its business, as well as other obligations arising from the plan. That money usually comes in the form of exit financing.

Exit financing is the access to capital an emerging, post-confirmation debtor uses to fund obligations created by the plan and provides working capital for ongoing operations. In many ways, exit financing is just an ordinary commercial loan agreement between a borrower and a lender on market terms and conditions. A lender, either new to the situation or an existing participant in the bankruptcy case, agrees to lend money to the debtor in exchange for a promise to get repaid, among others. There can be nuances and complications worthy of exploring.

Feasibility

To win confirmation of a plan, the proponent has to prove, among other things, that "Confirmation of the plan is not likely to be followed by the liquidation or the need for further financial reorganization" 11 U.S.C. § 1129(a)(11). Put colloquially, the plan must be feasible. Exit financing serves a key role in proving, and achieving, feasibility.

Exit financing often provides the debtor the funds necessary to make payments required under the plan. For example, the plan must require the payment in full of all administrative expenses and claims entitled to priority under 11 U.S.C. § 507 (unless alternate treatment is agreed). The exit financing can repay a debtor-in-possession ("DIP") loan, fund professional fee payments and other accrued but unpaid administrative expenses and fund wage and tax claims. In addition, the plan may require payments to be made to other creditors, either directly or in connection to some form of trust or other vehicle established to make distributions to creditors. And, of course, the debtor will need to prove it has adequate liquidity and working capital to operate its business post-confirmation and not fail or otherwise need further restructuring.

Part of the feasibility assessment the debtor must show is that the material terms of the exit financing are reasonable and manageable. Those terms include the maturity date, amortization schedule, interest rate, covenants, conditions and fees payable under the financing. Not only must the debtor show that such terms will not result in a swift default, the debtor also must show it is getting a fair deal.

In the confirmation order, the court often will find and conclude that the exit financing included in the plan is an essential element of the plan, is necessary for the confirmation and consummation of the plan and critical to the success of the plan. In addition, the proponent will be likely to ask for findings of the court that the exit financing reflects an exercise of the debtor's reasonable business judgment and was negotiated in good faith and at arm's length. Finally, to the extent liens are granted in connection with such exit financing, the court will make specific findings that those liens are appropriate and necessary under the circumstances.

Evidentiary presentation

Oftentimes, the debtor will submit evidence in the form of testimony from its financial advisor or investment banker to assist the court in making the required findings of fact about the adequacy and appropriateness of the exit facility. The nature of those findings can be very technical and likely must rely on projections and forecasting. The debtor's management may have the training, background and expertise to provide testimony in support of those findings. However, typically, the debtor will elicit expert testimony from its advisors: an investment banker or financial advisor, or both. That expert testimony provides a more independent and objective perspective on the debtor's plan that can both aid the court in making the necessary findings and conclusions and also help the plan withstand objection from disgruntled or hostile parties in interest.

The investment banker's testimony would demonstrate the good faith, arm's length nature of the negotiations with the exit lender, the extent of the market for exit financing and the way in which the proposed exit financing comports with the market existing for the debtor under the current circumstances. Arming the court with a sufficient factual record is critical, and perceptively simple things — like the arm's length nature of the negotiations — can be overlooked. With a comprehensive record from the party that not only advised, and perhaps negotiated on behalf of, the debtor on the specific exit financing, but also has a demonstrably expert understanding of the market for such financing and the manner in which such financing is negotiated, the court should be comfortable that the debtor's exit financing is the best deal it could get under the circumstances and that the deal it did get is a fair one given existing market conditions.

The debtor's financial advisor's testimony provides evidentiary support for the debtor's financial projections. Those projections are required so that the court, and all parties in interest voting on the plan, can have comfort the debtor actually will survive and thrive post-confirmation. And, of course, those projections must show that the reorganized debtor can service and eventually pay off the exit financing. Having an independent advisor provide that testimony will aid the court in analyzing whether the exit financing — and the rest of the plan — complies with the plan confirmation requirements of the Bankruptcy Code. That advisor's testimony and opinion likely will be respected as an expert opinion and, moreover, will confirm the projections and forecast were professionally prepared and free from any inherit bias that may come from the debtor's employees and officers. Among other things, having respected and experienced restructuring advisors testify that the debtor has the ability to achieve the forecasted results imbues the debtor's projections with a degree of independence and objectivity.

The projections and forecasts will probably have been constructed and refined well in advance of confirmation, likely even before the filing of the bankruptcy case. At a minimum, the disclosure statement will have described the key terms of the exit financing, including the identity of the exit lender or lenders, the anticipated loan amount, the interest rate and the maturity date. In the event the debtor is planning a short stay in bankruptcy, either via a pre-packaged or pre-arranged plan of reorganization, the exit financing will be fully baked or nearly so, at the time of the filing. The diligence required by the lender and the negotiations with the debtor likely will include a critical examination of the debtor's projections and forecasts, as well as the debtor's business plan, an assessment of the debtor's industry, the valuation of collateral (if any) and an assessment of management and their skills. That examination likely will create refinements and improvements and generate an exit financing facility that will lead to confirmation of the plan.

Existing party or new party as exit lender

In many instances, the exit lender already is a lender to the debtor in some capacity. As such, it will have substantial knowledge about the debtor, its business and its prospects going forward. Of course, that could be a double-edged sword. An existing lender may need less diligence and could be ready much more quickly than a party starting from scratch, but they may also have preformed opinions about the strengths and weaknesses of the management teams and the business' prospects. Continuing with a lender already in the deal, however, has the advantage of both procuring exit financing and addressing in the plan any claims that lender already had against the debtor. For example, if the exit lender also served as the pre-petition lender and the DIP lender, the plan, together with the exit financing package, likely will address that lender's pre-petition in DIP claims in a way that is satisfactory to that lender. Perhaps the lender essentially replaced the DIP loans and pre-petition claims with the exit financing facility, effectively rolling its claims over. In such an instance, the debtor will have mollified a very important creditor constituent whose vote likely is critical to the plan's confirmation while, at the same time, procuring the needed financing to generate a feasible plan.

When the exit lender is new to the deal, a few variables are injected into the mix. For starters, that new lender will need to be located, which may require a process run by an investment banker. That adds time to the reorganization case, both for the locating and for the diligence the lender will need to undertake before committing to make the loan. Once that lender is located and it has done its diligence, the debtor must be confident the lender is sufficiently capitalized and capable of closing the financing transaction and funding all amounts necessary and required. Not only will the debtor have to prove this as part of its feasibility presentation, but having the peace of mind that the lender is a serious, sophisticated, experienced market participant is valuable. The next question is whether the exit financing will pay off in full any DIP or pre-petition secured debt. If so, then the debtor needs to focus only on getting a payoff letter from the outgoing lenders and making sure the exit financing is sized appropriately to cover the payoff and the debtor's working capital needs post-confirmation. But if the debtor is looking to cram down its existing lenders, then the debtor faces two key hurdles as it relates to exit financing. First, of course, the debtor has to win a cramdown fight. The Bankruptcy Code requires that a plan must treat a nonconsenting secured creditor in a way that the secured creditor retains its liens and that it receives, on account of its claim, cash payments over time in an amount equal to the value of the collateral securing its claim at a market rate of interest. The standards for each aspect of cramming down a secured creditor are nuanced and challenging. For the purposes of analyzing exit financing, however, the debtor must ensure the amount of exit financing is sufficient to make the payments required to the crammed down lender. In addition, the exit financing lender must be comfortable with its lien priority and the debtor's assets post-confirmation. For example, the parties need to determine if the crammed down lender will have junior or senior liens and, in either case, if the exit lender is comfortable with the debtor's ability to make all the required payments or, in a downside scenario, that the collateral value covers its claims. And, of course, both the debtor and the exit financing lender must be comfortable with the risk that confirmation may be denied. Unlike an instance where the plan has received all the votes needed for confirmation or where the classes being crammed down have lower hurdles — like unsecured creditors or equity interest holders — cramming down a secured creditor is a challenging endeavor that requires a trial on the merits, with significant expert testimony on valuation and the existence of an efficient market. Plus, the opponent likely will be a well-capitalized and well-represented lender that will fight being crammed down vigorously.

Rights offering

Another aspect of exit financing often utilized is a rights offering. Rights offerings present an opportunity to purchase new equity or debt in the reorganized debtor typically at some form of discount. Generally speaking, the plan will provide a right for a class of creditors or perhaps equity interest holders to purchase debt or equity in the reorganized debtor. Usually, the rights offering is limited to a specific percentage of the exit financing or equity package being proposed under the plan. The plan will include rights offering procedures that typically have been approved by the bankruptcy court at the disclosure statement stage or in connection with confirmation. The procedures will set out which creditors or other stakeholders are eligible to participate, how much any one participant is permitted to participate, how to deal with having too many or too few participants and the date by which participants must participate.

Rights offerings are useful tools for creditors or equity interest holders to participate directly in the debtor and enhance their recovery. It is not unusual for creditors or equity interest holders to argue that the debtor is not appropriately valuing itself in connection with its plan. Parties with interest lower in priority may try to argue the debtor is much more valuable, requiring bigger distributions for more junior stakeholders. Offering those junior stakeholders the opportunity to participate in a rights offering gives such parties an opportunity to put their money to work in defense of their arguments — to put their money where their mouth is, in effect.

Often, though, to make sure it will get sufficient subscriptions in a rights offering, the debtor will procure a backstop, typically from the party providing the balance of the exit financing. That backstop party agrees to take whatever portion of debtor or equity being offered through the rights offering that goes unsubscribed. That backstop party usually demands a fee for agreeing to provide the backstop. That fee makes commercial sense as that backstop party is agreeing to make funds available to fund the exit financing (and therefore not available for other purposes) in the face of not needing actually to extend the financing. Plus, the debtor can more confidently and effectively make its feasibility case by pointing to the existence of the backstop party, which will lead to the consummation of the needed exit financing. However, the amount and triggering events for that fee can be disputed or challenged by parties in interest in the bankruptcy case or the U.S. Trustee. Accordingly, the backstop party and the debtor typically will see to court approval of any backstop agreement and fee prior to confirmation.

Rights offerings potentially exempt from registration with the U.S. Securities and Exchange Commission

Registration can be time consuming and expensive, so avoiding those negatives by taking advantage of the exemptions in the Bankruptcy Code can make this a wise option. Section 1145 of the Bankruptcy Code permits the offer or sale of unregistered securities where the offer is in exchange for a party's claim or equity interest, or principally in exchange for a party's claim or equity interest and party for cash or property. So, to qualify for an exemption when securities are exchanged for cash or property, the rights offering cannot be primarily an effort by the debtor to raise capital. The participants, in addition to paying cash or property, must be exchanged for a claim against or an equity interest in the debtor.

Conclusion

Exit financing is a critical and fundamental part of a debtor's ability to confirm a Chapter 11 plan. As such, a debtor must take care to procure exit financing that empowers it to garner confirmation of its plan: with a robust record, and with the features needed to ensure compliance with the Bankruptcy Code and to maximize its ability to succeed post-confirmation.

15 EMERGENCE PLAYBOOK

FINANCIAL ADVISOR PERSPECTIVE

FTI Consulting

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Chapter 11 bankruptcy is a stressful and unfamiliar process for most business leaders and boards, which is why so much of their attention tends to be focused on getting the business into and through Chapter 11 successfully — with little time being left to focus on positioning the business for post-bankruptcy success. Unfortunately, this narrow focus can lead to sub-optimal results and missed opportunities.

The ideal time to start thinking about life after bankruptcy is *before* filing for Chapter 11 — or, if that's not feasible, then as early as possible. Thinking ahead and pro-actively developing post-emergence strategies and plans can help the business get a running start toward profitable and sustainable growth after emerging from bankruptcy.

A quick primer on the bankruptcy landscape

As noted in FTI Consulting's recently published report (*Emerge to Grow: Market Insights and Playbook for Achieving Profitable and Sustainable Growth Post-Bankruptcy*),[1] there were 665 Chapter 11 bankruptcies filed from January 2019 through May 2021. FTI's analysis focused on the 358 filings that involved liabilities of at least $50 million at filing — a threshold chosen to provide insights about larger companies with more complex businesses, capital structures and scale. According to the report:

— **Bankruptcies hit a 10-year peak in 2020:** Chapter 11 bankruptcy filings for companies with liabilities greater than $50 million increased by 53% from 2019 to 2020, most impacting these sectors: energy (25% of filings), retail & consumer (15%), healthcare & pharma (9%), telecom & media (5%) and hospitality & leisure (5%).

— **Pre-packaged bankruptcies increased as a filing strategy:** Pre-packaged, pre-arranged and pre-negotiated bankruptcies ("pre-filings") increased markedly from 2019 to 2020. Pre-filings accelerate the bankruptcy process and shorten timelines, making it especially important for companies to develop a pre-filing strategy and operating plan to achieve profitable and sustainable growth on emergence.

[1] https://www.fticonsulting.com/insights/articles/emerge-grow-market-playbook-profitability-post-bankruptcy

— **The vast majority of businesses successfully emerged from bankruptcy, most as private companies:** Of the 134 Chapter 11 cases that were confirmed or closed from January 2019 through May 2021, 88% of the underlying companies successfully emerged from bankruptcy – 13% as public companies and 75% as private companies.

— **Repeat filings are common:** Between January 2016 and May 2021, 69 companies filed for a second, third or fourth Chapter 11 bankruptcy (based on a 10-year lookback period).

Emergence market survey

In addition to our bankruptcy landscape analysis, we conducted an in-depth survey of 50 business leaders from large companies with direct experience going through Chapter 11. The goal was to gain real-world insights about the bankruptcy process and how companies are planning to grow and thrive post-bankruptcy. Many of the questions focused on the five core business dimensions of *capital*, *cost*, *growth*, *technology* and *talent* — and the extent to which those dimensions were addressed during bankruptcy. According to the survey:

— **COVID-related factors were a major contributor to many bankruptcies:** Among the surveyed companies, the top three reasons for Chapter 11 filings were debt maturities or interest payments (64%), sales and supply chain problems due to COVID (48%) and liquidity issues (32%) – all of which had links to the global pandemic. That said, many bankruptcies were not directly attributable to COVID, with the global pandemic simply accelerating disruptive market trends and outcomes that were likely to occur anyway.

— **Capital was the primary focus during bankruptcy:** Capital was the top priority for the majority of respondents (56%), followed by cost (34%).

— **Most respondents believe they were not fully prepared for post-bankruptcy success:** Respondents said they were least prepared for post-bankruptcy success on the dimension of technology (14%), followed by cost (22%), talent (26%), growth (28%) and capital (32%). The speed of the bankruptcy process likely hampered the ability to address these topics.

— **Post-bankruptcy capital structures tended to be burdensome:** Seventy-two percent of respondents felt their post-bankruptcy capital structure was at least somewhat burdensome, and 26% considered it to be onerous or an inhibitor to growth.

— **Cost reduction was not aggressively addressed — especially strategic cost reduction:** During bankruptcy, only 12% of respondents aggressively addressed structural cost issues – such as defining a new operating model – that could have helped them achieve a scalable and sustainable cost structure.

— **Technology enablement during bankruptcy or emergence was uncommon:** Respondents' main technology focus was reporting and analytics. Implementation levels were significantly lower for transformational technologies such as cloud, IT modernization and enterprise data management.

— **Most companies did not identify and rationalize their most and least profitable customers:** Other growth actions received even less attention, particularly sales force incentives, international growth, marketing and advertising and commercial excellence programs. This lack of focus on profitable growth could hinder the chances for post-bankruptcy success.

— **Most companies in bankruptcy did not adequately address talent issues:** Only 16% of respondents felt they did very well at putting an effective executive team in place, likely given the inherent limitation of attracting new talent during bankruptcy. Human capital decisions are usually addressed post-emergence.

A playbook for profitable and sustainable growth after bankruptcy

Generally speaking, the preferred time to start positioning a business for its post-bankruptcy future is before or during the bankruptcy process, not after it emerges. In Chapter 11, a company has a unique opportunity to focus on the more profitable aspects of its business and create a stronger foundation for healthy, sustainable growth. And while there are certainly situations where consensus cannot be achieved on a company's five-year plan — or even on the correct timing to bring in transformational advisors or initiate strategic changes (given uncertainty around the final bankruptcy outcome) — it never hurts to have an established playbook for post-bankruptcy planning and success.

FTI Consulting has created a practical emergence playbook to help companies in bankruptcy quickly develop effective strategies, plans and business/operating models that address all five of the core performance dimensions: *capital*, *cost*, *growth*, *technology* and *talent*.

The playbook features four archetypes that differ based on two key variables: (1) the need to address immediate *capital* issues such as credit availability and (2) the need for *technology transformation* to enable growth.

— **Capital:** Some emerging companies lack sufficient capital to pursue growth and thus need to address their capital issues first, particularly credit availability (which only 10% of survey respondents said was substantially addressed during bankruptcy). Cost management initiatives — especially strategic improvements to a company's cost structure and operating models — can help companies generate the capital they need. Ideally, a cost management program can be designed so the timing and size of cost savings is sufficient to cover the required growth and transformation investments, ensuring the entire process is self-funded.

— **Technology transformation:** Profitable and sustainable growth can sometimes be achieved in the short and medium term through traditional mechanisms such as organic growth, acquisitions and expansion into new markets. However, in many cases profitable and sustainable growth can only be achieved through technology transformation — using innovative technologies to enable new products and services, as well as new business and operating models.

These two variables – *capital* and *technology transformation* – result in four distinct archetypes for successful emergence. Companies in all four archetypes have the potential to thrive after emerging from bankruptcy. However, the more complex archetypes require more time and effort and involve more risk (Exhibit 11).

— **Emerge-to-Grow:** Does not require capital/credit issues to be immediately addressed — or investment in enabling technologies — so it is the least complex and least risky archetype (and requires the least time to execute).

EXHIBIT 11. The four FTI Consulting Emergence Playbook℠ archetypes

FTI Consulting Emergence playbook archetype	Capital/credit availability need	Technology critical to enable sustainable growth short to mid-term	Stage I transformation key dimensions	Stage II transformation key dimensions	Implementation complexity and risk	Typical transformation duration
Emerge to Grow	No	No	Cost	Growth Talent		6-9 months
Enable Capital & Emerge to Grow	Yes	No	Capital Cost	Growth Talent		9-12 months
Emerge to Transform	No	Yes	Cost	Growth Technology Talent		12-18 months
Enable Capital & Emerge to Transform	Yes	Yes	Capital Cost	Growth Technology Talent		18+ months

Source: FTI Consulting, Inc.

— **Enable Capital & Emerge-to-Grow:** Adds capital/credit issues to the mix, so it is more complex and risky and takes longer to execute.

— **Emerge-to-Transform:** Does not require capital/credit issues to be addressed, but does require technology enablement, which tends to be more involved than capital enablement — so the related complexity, risk and time required are even higher.

— **Enable Capital & Emerge-to-Transform:** Is the most complex and risky archetype and takes the most time because it requires both capital enablement and investment in enabling technologies. However, the potential rewards may be the highest, particularly given the significant downside risks associated with a company that remains capital-constrained and fundamentally underperforming.

Sector- and market-specific dynamics can be a key determinant in defining a company's emergence archetype. Company executives or informed company stakeholders will typically have the in-depth knowledge necessary to identify the appropriate archetype.

The inherent transformational risk for each archetype — particularly as transformation risk increases relative to further capital enablement or technology transformational needs — helps explain why some companies may find themselves back in bankruptcy (since they might not have addressed the right transformation dimensions when emerging from bankruptcy the first time).

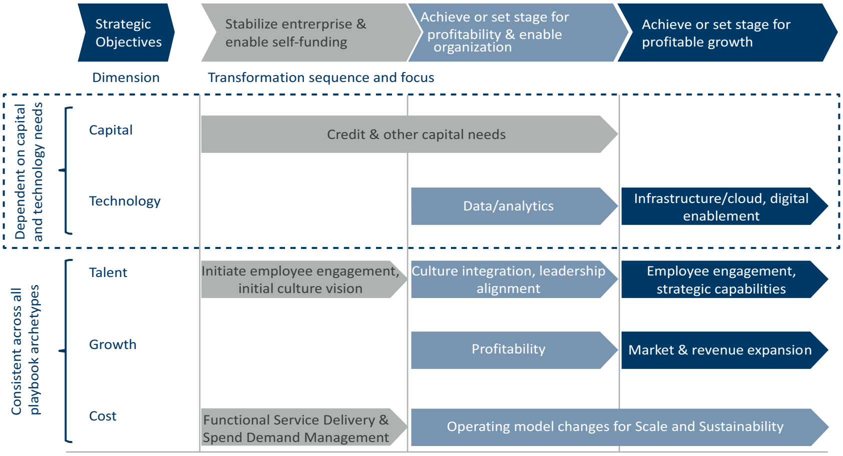
Putting the playbook into action

Each playbook archetype requires a unique three-phase approach, but with numerous elements that are common across archetypes. The first phase focuses on stabilizing the business and generating immediate cost savings that can help the entire emergence process become self-funding. The second phase focuses on improving profitability and initiating organizational readiness. The third phase focuses on pursuing and achieving profitable and sustainable growth (Exhibit 12).

Many companies and executives make the mistake of prematurely focusing on the last stage of profitable growth first — and end up falling short of their goals.

Note that the playbook and actions for *cost*, *growth* and *talent* do NOT change with each archetype, whereas the *capital* and *technology* strategies and tactics vary depending whether the emergent company has lingering capital issues that still need to be addressed, and whether technology transformation is required for sustainable growth over the short and medium term.

EXHIBIT 12. Playbook phases



Source: FTI Consulting, Inc.

With *Emerge-to-Grow*, the first phase of work includes tactical cost-reduction activities such as functional service delivery improvements and spend management, as well as talent-related readiness activities focused on culture and employee engagement. The second phase involves improving profitability and organizational readiness by: (1) initiating operating model changes that can deliver scalable and sustainable cost savings over the longer term; (2) shifting the business away from elements (customers, products and services, activities, markets, etc.) that are less profitable and toward those that are more profitable; and (3) improving culture integration and leadership alignment. The third phase continues the structural cost improvements from Phase Two — and begins to reap the benefits — while aggressively pursuing growth through traditional market and revenue expansion. The third phase also continues the focus on talent, increasing employee engagement and building strategic talent capabilities that can provide a long-term competitive advantage.

Enable Capital & Emerge-to-Grow has the same basic elements as Emerge-to-Grow, but with upfront capital enablement that might include supporting initial growth through senior debt (cash flow or asset-based) and other forms of working capital financing and, if necessary, pursuing junior debt or equity financing.

Emerge-to-Transform includes many of the same activities as Emerge-to-Grow but requires technology transformation to achieve profitable and sustainable growth. In terms of actions, the primary differences occur in Phase Two, with Emerge-to-Transform featuring a strong focus on data and analytics technologies to help the company zero in more effectively on its most profitable elements and opportunities, and in phase three where transformation is enabled by innovative digital technologies and infrastructure platforms such as cloud and Artificial Intelligence.

Enable Capital & Emerge-to-Transform is the same as Emerge-to-Transform, but with upfront capital enablement that might include seeking capital and liquidity sources that are likely to involve varying degrees of debt cost, collateral and priority of claims. The key is to ensure the company has the financial flexibility (i.e., no tight debt covenants) and sufficient liquidity to adequately support its entire transformation.

Conclusion

Although every situation is unique, the key takeaway is that bankruptcy often does not fully position the emerging business for accelerated transformational growth — largely focusing on capital issues while under-addressing the other key dimensions of cost, growth, technology and talent. Our emergence playbook tackles the challenge by giving companies a fact-based and customizable framework to help them quickly develop practical strategies, plans and business/operating models that address all five performance dimensions — ultimately enabling companies to more quickly achieve sustainable, profitable and transformational growth after emerging from bankruptcy and avoid financial under-performance or repeat bankruptcy filings.

16 A RARE LUXURY: REMAKING YOUR BOARD DURING A RESTRUCTURING

EXECUTIVE SEARCH PERSPECTIVE

Spencer Stuart

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Despite their many well-known challenges, companies in restructuring have a rare luxury: to completely reconceptualize and reinvent their board of directors, breathing new life and energy where it is often desperately needed. Our extensive experience working on the most prominent restructuring-related board builds since the outbreak of the COVID-19 pandemic has highlighted just how stark the contrast between these assignments and conventional board recruitments can be. Whereas the usual "board refresh" can take years, with new board members added only incrementally and occasionally, a company emerging from a reorganization or bankruptcy has a unique chance to reshape its board in one fell swoop to reflect its strategic direction, while also responding to both the challenges and opportunities of the reorganized company.

This was an opportunity that presented itself to many companies in 2020 and 2021. The pandemic led to an intense wave of bankruptcies, especially in the first several months, and particularly in sectors imperiled by the sudden and extensive deceleration in economic activity (e.g., travel, hospitality, retail and rental cars). In other sectors (e.g., energy exploration and production and offshore drilling), the negative impact of decreased demand pushed already weakened companies into insolvency.

For companies facing these circumstances, the board refresh can serve as a central element of rethinking their future. We have seen how creditor-shareholders can create significant value by seizing this opportunity and asking the right question at the outset — *What is our newly defined future and strategic plan and whom do we want guiding us there?* — and then building their board accordingly. In this chapter, we examine how creditor-shareholders can take advantage of this unique situation to create a board of directors that can drive success into the future.

Considerations in a board refresh

Corporate boards of directors are normally stable organizations; year-over-year changes are usually minimal, occurring most typically when directors reach retirement age. Bankruptcy is one of the only scenarios in which boards can be aggressively reinvented, usually from scratch. The stakeholders remaking the company following its emergence from the restructuring — typically pre-petition creditors and new money investors — have an opportunity to look at both board composition and company governance at a fundamental level.

The board is a critical component of a company's transformation from its previous identity as an overleveraged laggard to a newly recapitalized and reinvigorated organization. This calls for directors who are specialists in areas central to supporting the strategic course the new owners have charted for the company, and who have both the expertise and time needed to devote to the board.

Recruiting strong directors is difficult for any board, and there are distinct challenges for companies that have endured the public perception of a costly and often contentious bankruptcy process. But before even considering the issue of whom to recruit, there is usually an initial hurdle to surmount: finding a way to shift the focus of the creditor group (which typically selects the new directors) away from the narrow interests of each party to a broader focus that will serve the post-emergence company's interests in both the immediate and longer terms.

With that in mind, there are several fundamentals at play when constructing a new board:

— **Defining the capabilities needed to drive the change agenda:** First is identifying the characteristics of the independent directors who can carry the company forward. These are usually senior executives with both relevant industry experience and contextual expertise in companies undergoing meaningful transformation. In our broad work on non-distressed boards since the beginning of the COVID-19 pandemic, we have seen companies skewing toward experienced directors for open slots — executives who have been through crises and can provide expertise on how to navigate them — rather than up-and-comers. For companies emerging from a restructuring, particularly those where management turnover appears likely, this holds even more true. Conversely, we find that most companies emerging from restructuring are open to adding first-time directors to their boards; in these situations, the occasional "rookie" with specific and relevant expertise may be a strong fit alongside a fully refreshed slate of experienced directors.

— **Adding diversity:** Another advantage is the ability to add diversity to boards in a rapid manner, particularly in situations where regulations or best practices for public companies demand it. Our experience is unambiguous: assembling a diverse board, both demographically and cognitively, is among the most critical priorities expressed by our clients on both regular board recruitments and post-reorganization board builds. But our clients' ability to achieve this objective is dramatically higher in the latter.

— **Interim management candidates:** Many creditor-shareholders will be looking for possible management candidates should they decide that new leadership is needed. In a conventional board search, capacity to take a management position is seldom a factor in a director's candidacy. The owners of post-reorganization companies are almost always at least considering the possibility of replacing certain members of the management team. In refreshing a board, many of our clients explicitly seek a few director candidates who have the leadership depth and credibility to step into a leadership role — at least on an interim basis — if needed.

A blueprint for building a board

Our decades of experience as trusted advisors to organizations looking to enhance their boards as well as our knowledge of the restructuring process and players have given us a unique opportunity to work with companies who have to completely remake their boards of directors. Looking across many of these engagements, we have developed best practices that create a reliable blueprint for building a board.

Start with strategy

Building a new board needs to begin with a thoughtful, detailed process and upfront planning before the outreach to director candidates begins. Regardless of the specifics of the situation, the foundation of this process is a thorough understanding of the future strategy of the company. In distressed situations, the new directors will be crucial to helping regain credibility with key investors, customers and other stakeholders (e.g., regulators).

In these situations, understanding the strategy enables the next logical step: determining the combination of skills, backgrounds and knowledge needed on the board to evaluate and propel the strategy, and to assess the management team's progress in executing that strategy according to plan.

Secure board leaders

Board leadership is always an important consideration to ensure the company gets off to a strong start, and this is even more crucial when constructing a new board. A strong nonexecutive chairman can be a key player in helping the board assess the strength and suitability of management for the restructured business and ensuring that early milestones set out during the restructuring are met. A nonexecutive chairman also serves as an independent voice to stakeholders.

That said, whether to recruit a nonexecutive chairman as an "anchor director" at the outset of the board-build project is a common discussion point, and there is no single path to making this determination given the many considerations at play. For example, for one of our clients rebuilding its board, filling the chairman position was the priority. The owners sought someone who could give the company credibility with other board candidates, help develop the governance strategy and play an integral role in filling the board with the right people. Other companies consider the board's skills first; they simply want the best people, and then select the leader after putting together the right team. Ultimately, client preferences vary, and the individual situation will dictate the optimal approach.

Create a matrix of desired board skills

Given the complex strategic, operational, financial and legal aspects of restructuring, there is a need for directors with significant financial acumen and industry-specific knowledge, as well as those who have the bandwidth to dedicate to the board's work. A common fallacy is to believe that the company's restructuring is behind it at emergence; experienced directors understand that the post-emergence board inherits oversight of a damaged company — to varying degrees, of course — when its directors take office.

We have found it essential to identify the targeted capabilities of the board at the outset, and we often employ the use of a skills matrix to ensure that the board possesses the diverse range of attributes typically sought. Each square of the matrix reflects a "must have" or "nice to have" skill or experience found in a single director, and setting out these *individual* capabilities side-by-side facilitates a visual comparison of the *overall* capabilities of the board taken as a whole. These attributes include prior board experience, industry expertise, specific board committee experience (audit or compensation, for example) or specialized expertise in areas such as international trade, marketing, technology, compliance, human capital transformation or mergers & acquisitions ("M&A"). The matrix also illustrates demographic data, such as age, race and gender. Once the parameters of the matrix are developed, each candidate can be mapped onto it, with the objective of ensuring that every priority requirement is met when recruiting directors.

Matrices and priorities will, of course, vary depending on the nature of the business, its strategy and current situation. For example, in a company whose bankruptcy was precipitated by sector-specific overcapacity, future consolidation may be inevitable. In these circumstances, it may be invaluable for the board to have one or more directors with extensive M&A and capital allocation experience to ensure that the board can effectively evaluate a wide range of potential strategic alternatives following the company's emergence.

An important category in the matrix is diversity. Rather than being considered as an end in itself, diversity is increasingly viewed as an underlying dimension or criterion when potential directors are sought for skills or experience. Most companies today recognize the value of diverse perspectives on the board — in terms of age, gender, race, ethnicity, geography and academic background, among other factors. Diversity of thought expands the board's potential range of views on issues, options and solutions and this diversity (both demographic and cognitive) is increasingly acknowledged to be an indispensable feature of robust board discussions and deliberations.

Committee requirements are also a factor. In addition to the audit committee, the board needs knowledgeable independent directors to lead and serve as members of the compensation and nomination and governance committees. For a compensation committee chair, the desired background might include a public company CEO with significant board experience, someone who has previously served as a compensation committee chair, or others with HR transformation or compensation expertise. The nominating committee chair should be a board governance expert with a thorough understanding of best practices and evolving trends in corporate governance.

Consider the board culture and organization

A successful board not only brings together varied experiences, expertise and perspectives — it also works well together. The best boards know why they have been recruited and what is expected of them, both individually and collectively.

Teamwork is critical to the effective working of a board. Creditor-shareholders leading the search committee will be able to develop a feel for a candidate's fit for the desired culture in their interviews with a prospective director. Candidates should have an informed and contemporary view on governance, neither diminishing its importance nor allowing compliance to overshadow the board's broader role in strategy and succession planning. The best directors are willing to make tough decisions and to be accountable for results while simultaneously being open to dissenting perspectives from other board members and maintaining a helpful posture as a "team player." They are able to question, discuss, listen, express an opinion and articulate differences in a constructive way.

This is particularly true as a new shareholder group creates a new board from scratch, without the benefit of past context, culture, or relationships. Many new boards start the culture-building process by having directors regularly meet — virtually or in person (say, over dinner) — before each board meeting. Informal dinners or similar social gatherings allow directors to bond before they begin to work as a group. Many "pre-meet" as a way to familiarize themselves with the important business issues or governance-related topics facing their company, so they are prepared for the first formal board meeting, when they must begin to deal with live board issues in real time.

Of course, not every board has the luxury of time prior to emergence to gradually acclimate directors — particularly when the governance picture is left to the late stages of a restructuring transaction. Many of our clients simply need a top team as quickly as possible. But, when possible, creating cohesion among directors early pays dividends down the road as the board tackles the organization's toughest issues under time pressure.

Understand special considerations for different scenarios

Just as no two restructurings are alike and there is never one simple reason for why the company was forced to restructure, when it comes to finding the "right board" every company will be facing different historical contexts, constraints and industry (and intercreditor) dynamics. Our clients invariably tailor their boards to respond to their specific challenges, which are as diverse as the themes that prevailed during the reorganization.

In some situations, the right choice may not be the intuitive candidate with the most industry or operational expertise, but rather someone who may have experience in a completely different sector but possesses highly relevant skills. For example, we recently worked on a board build for a company that needed a top-down transformation at all levels of the company after its emergence; this client group ensured that one of its seats went to an HR expert who had led transformational culture change following a highly visible reputational problem. This skill set was identified early and was prioritized during the recruitment, and that board member is currently driving the beginning of the company's transformation in the C-suite.

Another common scenario is a fragmented creditor group where intercreditor factions have formed and the high temperature of contentious negotiations elsewhere in the case bleeds into the board selection process. Naturally skeptical of their fellow creditors following difficult zero-sum negotiations, certain creditors reflexively take rigid positions that can be counterproductive, particularly at the outset. For example, they voice inflexible views on the categories of the target matrix, or strong skepticism regarding a fellow creditor's candidate nomination (fearing that another creditor is advocating for "their" director). We frequently find ourselves working to diffuse these tensions and continually focusing the conversation on the candidate's objective capabilities. Our experience has taught us that frequent reiteration of the potential contributions of a given candidate usually focuses our clients on their shared values and objectives, and that insurmountable differences of opinion on specific candidates during the interview process are quite rare.

Board refresh: getting the ball rolling

The inescapable reality of complex restructurings is that there are many simultaneous topics that require energy and attention, and selecting board directors is merely one of them. Clients who engage us on a post-restructuring board build often have little time; they need a top-quality board, and they need it fast.

In the best-case scenario, however, board composition and governance should receive attention as early in a restructuring as possible. What kind of board leadership is best for our company? What committees will be established at the outset? What skills, expertise and culture do we want in our boardroom to help push our newly restructured company to success? The sooner these questions are answered, the more effective the board of directors will become.

While there is no single formula for success, with a measured approach — and by making boardroom best practice a central part of the rebuilding strategy from the beginning — companies emerging from restructurings can find the board leadership needed to move forward and thrive, and shareholders who seize this opportunity can create outsized value from their investments.

17. BANKRUPTCY: CONSIDERATIONS AND STRATEGIES FOR DIRECTORS AND OFFICERS OF MULTINATIONAL COMPANIES SEEKING TO RESTRUCTURE

LEGAL PERSPECTIVE

Cleary Gottlieb Steen & Hamilton LLP

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Directors and officers of multinational companies considering restructuring should be aware of the viability of using Chapter 11 of the United States Bankruptcy Code to effectuate a successful financial or operational restructuring. Chapter 11 provides key advantages for a debtor compared to local insolvency policies in other countries. Directors should understand that their fiduciary duties when a company approaches insolvency or is insolvent may vary across jurisdictions, and that consideration must be given to the local regulatory environment in terms of planning a successful restructuring. There is a strong precedent of foreign directors and senior management approving Chapter 11 filings as the best available alternative.

Key attractions of a U.S. Chapter 11 process

Companies with and without substantial operations in the United States are increasingly opting to file for Chapter 11 as their main restructuring proceedings. While many multinational companies may be familiar with Chapter 15 of the U.S. Bankruptcy Code as an ancillary proceeding used to give effect in the United States to insolvency proceedings conducted outside of the United States, Chapter 11 is also available to domestic companies with substantial foreign operations as well as foreign companies with or without any U.S. operations. Indeed, Chapter 11 has been used by foreign companies across a wide variety of industries to implement restructuring agreements reached with major creditors (through pre-packaged bankruptcies) and to obtain breathing space to develop a reorganization plan. For example, major airlines in Chile, Mexico and Columbia sought Chapter 11 relief to reorganize after the COVID-19 pandemic hit, as did the world's largest offshore and well drilling company based in London. There have been multiple Chapter 11 filings in the fourth quarter of 2021 by foreign companies, including a pre-packed Chapter 11 case filed by one of the largest hotel operators in Mexico and a pre-arranged Chapter 11 filing by a Chile-based hydroelectric power project along with its U.S. affiliate. There have also been pre-packaged Chapter 11 filings by foreign companies where the debtor sought and received bankruptcy court approval of its proposed

Chapter 11 restructuring plan within hours of the company's filing, including in the Chapter 11 cases of a Helsinki, Finland-based business-to-business-for-employees travel management company and in the case of Seadrill New Finance Ltd. Foreign companies' use of Chapter 11 to reorganize is likely to continue given Chapter 11's distinct advantages for companies seeking to restructure.

Barriers to entry for filing Chapter 11 are low. Unlike in various other jurisdictions, companies do not need to demonstrate insolvency to file Chapter 11; they merely have to be experiencing some financial distress. They do not need substantial operations in the United States to avail themselves of Chapter 11's protections. In fact, if a company "resides or has a domicile, a place of business, or property in the United States," (11 U.S.C. § 109(a)) it can be a Chapter 11 debtor. Foreign companies typically file based on the existence of property located in the United States, where even a minimal amount of assets such as receivables owed by U.S. counterparties, local bank accounts or even a prospective debtor's funds held in a lawyer's retainer account, may be sufficient for establishing Chapter 11 eligibility. (*In re Glob. Ocean Carriers Ltd.*, 251 B.R. 31, 39 (Bankr. D. Del. 2000) holding that retainers paid on behalf of the debtors were sufficient property under the Bankruptcy Code).

Once in Chapter 11, a debtor will benefit from an expansive automatic stay. The automatic stay in bankruptcy immediately prevents any creditor actions against the debtor or its property outside of the bankruptcy proceeding, including any attempts to collect or enforce claims against the debtor (11 U.S.C. § 362). The automatic stay has purported worldwide applicability, and for creditors with significant U.S. ties such as international financial institutions, there is a strong incentive for such creditors to abide by the stay or otherwise risk facing contempt in a U.S. court (even though such creditor's underlying claims may be based entirely in a non-U.S. jurisdiction with little or no connection to the U.S).

Plan confirmation under Chapter 11 is flexible and the debtor can bind holdout creditors. Within one class, a debtor needs only to obtain the consent of a majority in number and two-thirds in amount of voting creditors for that class to accept the plan (11 U.S.C. § 1126(c)). By contrast, many other jurisdictions, including the United Kingdom and Hong Kong, require thresholds greater than 50% of voting creditors to bind the class. Moreover, Chapter 11 debtors are able to "cram down" a plan, i.e., to impose a plan on non-accepting classes of creditors as long as certain conditions are met (11 U.S.C. § 1129(b)). In order to cram down a Chapter 11 on a non-accepting class, the debtor must show that the plan is fair and equitable in accordance with the Bankruptcy Code (junior creditors are not paid until senior ones are paid in full — the so-called "absolute priority" rule) and does not unfairly discriminate against a class of creditors; such creditor classes do not receive worse treatment than other similar creditor classes. Other common law jurisdictions either offer no such cram down, or in the case of the United Kingdom, only recently adopted a similar procedure by amending insolvency law through the Corporate Insolvency and Governance Act 2020.

Under the U.S. Bankruptcy Code, Chapter 11 provides additional tools and powers advantageous to multinational companies:

(i) A trustee is not typically appointed, and existing management of the company remains in control after the filing of Chapter 11. The debtor is allowed to operate its business as a debtor-in-possession ("DIP") except in extraordinary circumstances, such as fraud or gross mismanagement where a trustee may be appointed on request (11 U.S.C. § 1104).

(ii) Companies have access to financial markets in the United States while in bankruptcy through so-called DIP financing. To attract existing lenders or third parties to provide additional funding, the new financing can be senior in payment priority and receive liens that are senior to existing secured claims subject to certain showings. The DIP financing market is well developed in the United States, and each of the major foreign airlines that filed Chapter 11 in 2020 obtained DIP financing notwithstanding the pending pandemic, including LATAM Airlines

($3.2 billion), Avianca Holdings ($2 billion) and Grupo Aeroméxico ($1 billion).

(iii) Under the Bankruptcy Code, Chapter 11 debtors have a broad right to assume (maintain and perform) or reject (effectively breach and not perform further) executory contracts at any time during the Chapter 11 proceeding (11 U.S.C. § 365). Executory contracts are pre-bankruptcy contracts where both parties have material performance obligations remaining as of the time of the case filing. A debtor's ability to reject disadvantageous contracts (where rejection typically results in an unsecured pre-petition claim for damages that can be compromised in the case) is critical to debtors needing to respond to changed market conditions, such as the foreign airlines that filed Chapter 11 in 2020 as a result of the COVID-19 pandemic who needed to reject or renegotiate numerous contracts related to their businesses. Additionally, the mere threat of rejection can be a useful tool for debtors seeking improved terms of their existing contracts.

(iv) A debtor, or in some cases, certain third parties, may pursue avoidance actions to unwind certain transfers made by the debtor prior to the bankruptcy filing (11 U.S.C. §§ 547, 548). Chapter 11 is useful for companies considering a reorganization that may have significant value in potential clawback claims because this avoidance power is unavailable under a Chapter 15 ancillary proceeding. Notably, U.S. avoidance actions are broader in scope compared to certain other jurisdictions, including with respect to the applicable look-back period, so debtors may be able to improve recovery of value on behalf of the estate through these claims.

(v) Finally, Chapter 11 can enable a debtor to sell some or all of its assets free and clear of existing liens and claims, with any security interest in the assets sold typically attaching to the proceeds of the sale subject to certain requirements (11 U.S.C. § 363). Bankruptcy sales can be relatively quick (sales may be completed in two to four months or even less depending on the specific circumstances). In August 2021, for instance, Alpha Latam Management LLC and its affiliates in Colombia and Mexico filed Chapter 11 to commence a sale process for their Colombian assets. In their declaration supporting the bankruptcy petition, the debtors specifically referred to the attractiveness of selling assets free and clear under Section 363 of Chapter 11: "[i]t quickly became evident, however, that potential buyers would be unwilling to pursue a purchase of the Colombian loan portfolio outside a sale under section 363 of the Bankruptcy Code."

Practical considerations for directors of multinational companies considering restructuring

When considering a restructuring through Chapter 11, directors of multinational companies should be aware that their fiduciary duties may differ across jurisdictions. For example, in the United States under Delaware law, the state where many U.S. companies are incorporated, directors are largely shielded from creditor lawsuits based on the business judgment rule; they may choose to file bankruptcy or continue to operate an insolvent entity outside of a proceeding so long as they act in good faith to the best interest of the corporation (*N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007); *Quadrant Structured Prod. Co., Ltd. v. Vertin*, 115 A.3d 535, 547 (Del. Ch. 2015)). This is not always the case in other countries, especially in certain European jurisdictions. While U.S. directors' fiduciary duties remain with the company throughout, and case law has moved away from heightened duties in the "zone of insolvency," in some jurisdictions such as the United Kingdom and Luxemburg, director duties may shift as the company approaches insolvency to the protection of creditors. In various countries, including Belgium, France and Germany, directors may be required to commence formal insolvency proceedings within certain prescribed time periods after a company becomes insolvent. Failure to do so could subject the director to personal civil liability for losses or even potential criminal liability in certain countries. In various prior cases, directors have been comfortable with the idea that the commencement of a Chapter 11 proceeding may satisfy their statutory duties with respect to these matters.

After a company enters Chapter 11, its directors may face a multitude of critical decisions, including whether to (i) sell parts of the company or potentially the entire company; (ii) enter into restructuring support agreements with certain creditors or stakeholders; (iii) approve a Chapter 11 plan and the terms of such plan; and/or (iv) issue new debt and/or equity as part of the capital structure of the reorganized entity. While the board is a fiduciary for all stakeholders and has an obligation to seek to maximize value for all stakeholders, in making its decisions the board can take into account factors other than valuation, including whether the relevant transaction involves material regulatory or other risks or is compliant with other requirements of the Bankruptcy Code (including, in the case of a plan of reorganization, whether it satisfies the requirements of Section 1129 of the Bankruptcy Code).

For foreign filers seeking to confirm a plan of reorganization, one particularly important requirement is that the plan comply with all applicable laws, including those that may apply in its jurisdiction of reorganization. Corporate laws in a debtor's home country regarding corporate governance and shareholder rights may materially affect the negotiation of a plan to exit Chapter 11. For example, parties may have to negotiate and develop workarounds where requirements in the Bankruptcy Code such as the absolute priority rule might seem at odds with certain corporate and securities law requirements in foreign legal regimes, including, in certain jurisdictions, vesting existing shareholders with the exclusive right to approve and/or participate in a capital-raise (*See* Richard J. Cooper, Kyle J. Ortiz, and Thomas S. Kessler, *Addressing Treatment of Equity of Foreign Law and the Code,* ABI JNL., Vol. XL, No. 4. (2021)). In some recent Chapter 11 cases, squaring the legal requirements of a company's home jurisdiction and the requirements of Chapter 11 has generated a great deal of litigation. For example, in the Chapter 11 cases of both LATAM Airlines and Aeroméxico, parties have raised objections to proposed distributions of value that are required by local law.

For companies with assets and creditors located in multiple jurisdictions, the debtor also may want to seek recognition of the U.S. Chapter 11 proceedings in their home country or other foreign jurisdictions. The recognition of the Chapter 11 proceeding in other jurisdictions may serve to enforce the statutory stay and further protect the debtor from needing to litigate with creditors who do not have ties to the United States in local courts. While recognition may be relatively straightforward in jurisdictions that have well-developed cross-border insolvency regimes such ones patterned on the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law"), a debtor may consider alternative options for enforcement of the bankruptcy protections to the extent statutory recognition procedures have not been implemented in a specific country. For example, Philippine Airlines Inc. recently obtained a Philippine local court's recognition of its U.S. Chapter 11 proceeding, a first for the country.

In addition to recognition, local law may require the company to take action or may prevent the company from utilizing the provisions of Chapter 11 that otherwise might be available in ways that may affect the conduct of the case. For example, local labor and union law could affect companies in a Chapter 11 proceeding where the company will want to maintain its relationships and agreements with unions and employees but may also want to obtain concessions from them as a key component of the restructuring process. While a U.S. debtor may reject a collective bargaining agreement subject to certain conditions (11 U.S.C. § 1113), a foreign filer may not necessarily be able to do so under relevant local law. In contrast, a foreign debtor may wish to provide financial protection to certain of its senior management immediately prior to or over the course of a Chapter 11 proceeding in order to ensure their retention. The Bankruptcy Code contains certain limitations on a debtor's ability to pay bonuses to employees which the board should be aware of before it enters into a Chapter 11 case. A debtor may make payments to key employees under a Key Employee Retention Plan upon approval of the bankruptcy court and after a showing that certain required factors have been satisfied (11 U.S.C. § 503(c)(1)). Chapter 11 debtors may pay a bonus under a Key Employee Incentive Plan with bankruptcy court approval, if such employees meet certain measurable milestones and the debtor sufficiently demonstrates to the bankruptcy court that such payments are justified by the facts and circumstances of the case (11 U.S.C. § 503(c)(3)). Companies should consider potential employment issues beforehand and develop a plan to effectively communicate with domestic and foreign employees and any unions regarding Chapter 11.

As debtors-in-possession in Chapter 11, foreign companies must also be aware of certain statutory reporting requirements contained in the U.S. Bankruptcy Code and reporting rules required by the Office of the United States Trustee, both upon filing the case and during the bankruptcy. One area that is particularly important relates to a debtor's cash management system, including the deposit and investment requirements under section 345 of the U.S. Bankruptcy Code. The U.S. Trustee, a bankruptcy administrator under the U.S. Department of Justice, also adopts reporting rules regarding bank accounts that debtors-in-possession must follow. Multinational companies considering a restructuring through Chapter 11 should conduct detailed analysis of location of their cash as well as expatriation options and limitations to ensure compliance with both local financial laws and the U.S. Bankruptcy Code.

In Chapter 11 cases, various committees of creditors and other stakeholders may take an active role in the case. Most commonly, an unsecured creditors' committee ("UCC") may, with court approval, investigate the debtor, its financial affairs and its business operations and object to certain relief sought or commence various litigation. The costs of the UCC's advisors are paid by the bankruptcy estate and a debtor will generally have to work with the UCC throughout the case, as the UCC will often be a key constituent with respect to approval of a Chapter 11 plan.

Finally, to maintain its global operations, a multinational debtor will likely have to be able to pay critical vendors that reside in non-U.S. jurisdictions. One way a debtor can obtain authority to do so in Chapter 11 is for the debtor to seek a foreign vendor order from the bankruptcy court that authorizes the debtor to make payments to foreign vendors on account of all or a portion of the debtor's pre-petition obligations to such foreign vendors. A foreign vendor order may minimize the risk that notwithstanding the statutory protections afforded by Chapter 11, a foreign vendor may seek to withhold goods or services or take enforcement action under local law which could include the involuntary commencement of insolvency proceedings and/or the assertion of personal liability against the debtor's directors or officers. Additionally, aside from its vendors, debtors hiring "professionals" for the bankruptcy case should be aware of the requirements contained in section 327(a) of the U.S. Bankruptcy Code indicating that such bankruptcy professional be "disinterested."

Directors of multinational companies and their legal advisors will need to consider local law in the jurisdictions in which the company operates when crafting a restructuring strategy. Any decision whether and where to commence a creditor protection proceeding requires a holistic assessment of the company's options and the relative benefits and limitations of different options. In various situations, Chapter 11 may prove to be superior compared to other local alternatives if the case is properly prepared and the potential risks are adequately identified and addressed in advance of a filing.

17.II BANKRUPTCY: CONSIDERATIONS AND STRATEGIES FOR DIRECTORS AND OFFICERS OF MULTINATIONAL COMPANIES SEEKING TO RESTRUCTURE

FINANCIAL ADVISOR PERSPECTIVE

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Introduction

Technological advancement and globalization have made the international business environment increasingly interconnected, and few businesses are unaffected in some way by cross-border interactions. Enterprise supply chains, customers, sales offices, centers of excellence and technology, joint venture locations and tax efficiency designs are increasingly multinational. As well, it is common for enterprises that were legacy centered in other jurisdictions to have presence in the U.S. for accessing capital in public and private markets. The supply chain disruptions that arose during the COVID 19 pandemic and continue two years later are a glaring reminder of how globally connected business is. Over the last few decades, companies of all sizes have been able to expand internationally with ease and frequency, resulting in increasing complexity of their business operations as they operate under a variety of sovereign laws and regulations, economics, governments, financial markets and cultures. And while the playbook for global expansion is well documented and understood, the opposite is true for troubled international businesses looking to restructure – there is no roadmap, and each situation has a unique set of circumstances to be evaluated and managed to effectuate a successful restructuring.

The U.S. restructuring regimes offer what is arguably considered to be the world's most predictable, powerful and well-tested forum for resolution and reorganization of an enterprise's liabilities. It is not always the best or first choice for foreign Centers of Main Interest ("COMI") entities, but should be tested, as most sophisticated enterprises do, to evaluate its use and the significant tools for debt rearrangements and liability management afforded by the U.S. Bankruptcy Code to qualified companies.

Although the right and defensible decisions on Chapter 11 protection for foreign entities can only be made from careful analysis by skilled lawyers with the assistance of financial advisors who operate across global markets, below are some considerations that have resulted in increasing use of that framework and some items that must be vetted to ensure mission success.

Navigating venue selection

The U.S. bankruptcy system is unmatched as a forum for restructuring and provides companies with the opportunity and tools to reorganize and get a fresh start. Upon a Chapter 11 filing, a debtor immediately benefits from the automatic stay, which provides an injunction against actions against the debtor, providing space and time to execute on the restructuring, including a broad stay of litigation, lien enforcement and almost all other actions that are attempts to enforce or collect pre-petition claims against the debtor. In Chapter 11, management also remains in control and continues to operate the business as a debtor in possession, except in extraordinary circumstances. This system, however, is not globally recognized and enforceable and developing a careful understanding of where U.S. Court orders will be timely and effectively enforced is key to an effective global restructuring. In many jurisdictions issues such as real estate ownership and financing, labor and the powers of and relationships to work councils and pension administrators are very “local” and a careful review with counsel and financial advisors will be imperative to map how a Chapter 11 will work to manage these matters if that is possible.

Choosing the right insolvency path

There are advantages and disadvantages, and cost considerations to choosing Chapter 11 versus local countries’ court-supervised monitor, administrator, or trustee proceedings for a company’s debt management. These all need to be reviewed carefully on a case-by-case basis. While each system has merits and drawbacks, there is no question that jurisdictional inconsistency and the limited global reach of a chosen path can introduce risk and uncertainty for global businesses seeking an orderly restructuring. This lack of certainty can be an existential threat for a multinational corporate group if the preservation of the going concern depends on preserving the confidence of creditors, business partners, employees and subsidiary directors around the world. It is noteworthy that other jurisdictions have been supplementing traditional ‘schemes’ with other means of affording continuing control by existing leadership, and these should also be examined as they become better understood and more certain.

Many corporate groups have subsidiaries and material assets in dozens of non-U.S. jurisdictions, each of which may require prompt recognition of the parent’s home country proceeding under local law to protect the relevant assets. For the practitioner, every additional jurisdiction beyond the home country and the U.S. increases the challenges and uncertainties of a restructuring.

Differences in national insolvency laws have important consequences in cases where companies have operations (or assets and liabilities) in different countries, and significant planning goes into the choice of venue (or venues) and the cross-border coordination of proceedings to best position the company to achieve its restructuring objectives.

Employees, trade and other creditors outside of the U.S. with few or no U.S. contracts, as well as non-U.S. governmental creditors, are unlikely to honor U.S. court orders and local recognition may be a challenge depending on jurisdiction. Debtors and their advisors will plan from the outset of the case on how to deal with differences between international creditors (whom the debtor expects to follow U.S. court orders) and local creditors outside of the U.S. (whom the debtor expects will not). Local law and regulatory matters are often under local jurisdictional control exclusively and must be subject of legal advice.

One of the key and unique features of the U.S. Chapter 11 system is the ability to consummate a plan of reorganization that can afford a “fresh start” and give legacy officers and directors a legal release relating to pre-filing actions and liabilities of an enterprise. Developing a complete understanding of the end goals and path to exit is an extremely important part of the planning. Whenever possible, a prospective Chapter 11 debtor will want to know how and when it will emerge, and that it is sufficiently resourced to complete that plan before it enters the process.

Significant progress has been made to increase cross-border coordination and accommodate differences (and provide legal recognition of rulings in foreign proceedings), but the system remains far from perfect, and there are still several issues that directors and officers must navigate in multinational insolvency cases with the assistance of experienced advisors.

Director and officer liability issues

Laws in many jurisdictions can make it intolerably risky for debtors and officers of an enterprise to engage in ongoing business operations while insolvent. How that is defined, and its consequences are issues of local law and must be carefully considered on a jurisdictional and balance sheet basis to ensure that there is not undue risk for those responsible for operations and finance in local jurisdictions. Even if planning a U.S. Chapter 11 filing for a global enterprise, these analyses still need to be thoughtfully completed by the company with the assistance of skilled and knowledgeable financial advisors with the assistance of counsel. One of the greatest benefits of the U.S. Chapter 11 regime is that it leaves the directors and management in control of the enterprise as "debtors-in-possession ("DIP")," as opposed to schemes and arrangements in many other jurisdictions where a third-party administrator or provisional liquidator is appointed in an insolvency event- stripping away control from the legacy board. Nonetheless, local jurisdictional reviews described above must be done on an enterprise and jurisdictional basis, involving cash and liquidity considerations discussed below.

Cash and liquidity considerations

It is essential that an enterprise considering a restructuring path and jurisdiction have command over its liquidity and cash management regimen. Mastering the consolidated and consolidating financials and understanding cash flows and projections on an entity-by-entity basis are prerequisites. An eligible enterprise may consider a U.S. Chapter 11 filing because of the well-developed statutory and case law governing securing post-filing financing on a "super-priority" basis (referred to as DIP financing), which can be a very powerful and effective way to secure senior financing that might not otherwise be available. How that financing is secured, where it is funded and how intercorporate funds may be used are important considerations that will necessarily be impacted by the entities that are filed as U.S. debtors and the recognition of considerations discussed above. The DIP budget and plan for maintaining post-petition liquidity and the solvency of foreign entities is critical to the mission. Considerations will include, without limitation:

- providing financing to foreign cost centers for the good of the enterprise;
- cash pooling and management planning;
- cross-border collateral issues;
- intercompany trade balances and transfer pricing/ tax considerations;
- potential conflicts between creditors of U.S. Debtors and non– filing foreign affiliates;
- considerations relating to substantive consolidation among entities;
- litigation and judgment creditors; and
- risk of secondary insolvencies and need to advance protective funding.

Conclusion

The path to determining the right jurisdiction and method for debt adjustment and corporate recovery is one of the most complex and intensive exercises that an enterprise can go through. We've touched on some of the important considerations, which must be closely examined with the assistance of experienced advisors. Having high confidence in the path, the choice of venue, the required liquidity and the timeframe and milestones to finish the restructuring and "exit" is essential. Fortunately, the U.S. Chapter 11 process is increasingly available to global enterprises and should be carefully considered in view of the many well-tested available paths to restructuring- though each company and situation will be subject to unique considerations.

18 RESTRUCTURING VENTURE-BACKED COMPANIES: KEY CONSIDERATIONS AND STRATEGIC OPTIONS

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Companies with venture capital investors have the potential to disrupt industries and grow exponentially; however, such companies may eventually face difficulties executing their growth plans and securing successive funding. This chapter explores the key considerations and strategic options for venture-backed companies when they are faced with financial distress.

This chapter is divided into three sections. First, this chapter discusses the common features of a venture capital-backed company and the types of debt facilities available to such companies. Second, this chapter sets forth certain key considerations for a venture-backed company in distressed situations, including strategic considerations concerning the company's lenders. Last, this chapter introduces the in-court process, including: the circumstances under which a bankruptcy court restructuring may be preferable for a venture-backed company, common challenges facing venture-backed companies under a bankruptcy process and the alternatives to a formal bankruptcy process, most notably, an assignment for the benefit of creditors.

Distressed startups and other venture capital-backed companies: From high growth to a soft-landing

Venture capital-backed companies range from early to late-stage and are involved in a variety of sectors, but most have a few features in common that are key to a discussion of financial distress:

- **Growth over profits and cash burn:** Venture capital investors seek companies that have the potential to disrupt industries, address huge markets and scale and achieve exponential growth. At the expense of profitability, these companies have secured venture capital and invested in growth through product development and sales and marketing.
- **Financing and capital structure:** To fund this "cash burn," companies raise capital through preferred stock financings until the company is ready to either go public or (more often) get acquired. The goal for management and venture capital investors is usually

that each round of financing raises sufficient equity capital to fund the company until it can achieve a significant milestone and raise the next round of financing at a higher valuation or consummate a liquidity event.

— Each series of preferred stock typically has liquidation preferences that are senior to the prior round, meaning that if there is a sale of the company, the investors in that most senior round of preferred stock are entitled to receive the capital they invested (plus, in some cases, accrued dividends) before distributions are made to junior preferred holders or common holders.

— Also, the most senior series of preferred stock typically has the right to appoint at least one director. More junior series of preferred stock may or may not also have such rights; often founders and/or management also have board representation.

— Typically, no single investor has a controlling equity stake or controls the board. Instead, the support of more than one investor, and sometimes founders, is often required to approve a sale transaction. Holders of a junior series of preferred stock may also have approval rights, giving them the ability to require a higher acquisition price and enable them to at least break even on their investment.

A range of debt facilities are available to venture-backed companies, but a few common features include:

— **Underwriting:** Lenders rely on two key sources of repayment. The first is the prospect of the next round of equity investment. Second, is the business's enterprise value that could be realized in a sale. Lenders look to the track record of investors, the perceived level of support of investors and acquisitions of comparable companies. Lenders' assessment of the prospect of future financing or a sale of the company will inform how patient the lender is if the company stumbles on a plan of exponential growth.

— **Repayment terms:** Given the lack of positive cash flow, venture debt facilities typically are structured to defer principal payments. If the next round of funding or the anticipated liquidity event does not come together by the time amortization is scheduled to begin — even if the deal has no financial covenants — the amortization payments create pressure for the company to pursue alternative sources of liquidity to fund principal payments.

— **Collateral:** Facilities are typically secured by a lien on all personal property assets. In many deals, intellectual property is excluded from the collateral and lenders may ask for a lien on intellectual property as part of a restructuring of terms if the company runs into trouble. Because venture-backed companies typically do not establish a holding company, the lender does not have a pledge of the equity of the entity where valuable assets and business operations reside. This means lenders do not have the option of using a pledge of stock of the borrower to replace management and take more active control in a turnaround. Instead, in the typical venture debt collateral structure, the lender is limited to either foreclosing on assets in its collateral package or using leverage to push the company to sell itself.

— **Covenants:** Venture deals most often do not include financial covenants, but if they do, covenants are typically based on tracking either liquidity or performance to plan.

— **Defaults:** In addition to payment defaults, covenant defaults, insolvency defaults and other defaults typical in debt facilities, venture debt facilities often also include one or more discretionary default in the form of a "material adverse effect" or based on "investor abandonment." Lenders rarely invoke these discretionary defaults, but they provide a backstop to permit the lender to accelerate the debt if the investors walk away. Theoretically, "material adverse effect" comprises a broader range of circumstances, but in most cases, a lender would only "call" either of these subjective defaults when it appears more likely than not that the ultimate source of loan repayment is no longer a viable source.

Venture-backed companies in distress

With this background, consider a rapidly cash-burning, venture-backed company with secured debt as part of its capital structure. What happens when such a company runs into trouble executing its growth plan and securing successive equity financing rounds?

The first question a company likely faces is if, and when, to provide information to its lender about adverse developments. Monthly reporting of updated financial plans and notices of certain adverse events are typically required under a credit facility; however, it may benefit the company to confer with professionals and develop a strategy to address the situation. Is there alternative financing available that could shore up liquidity or refinance the debt? Is it possible to pivot the business? Is it feasible to sell the company, a line of business, or some material asset? Are investors supportive of the Plan B strategy? Is it possible to reduce cash burn in the meantime? Lenders are typically keen to know whether investors remain supportive and if so, are willing to provide additional financing to support the company through the execution of the revised plan.

It is often necessary to reset the terms of secured financing and/or investor rights to support a revised plan. The financial covenants, if any, may need to be adjusted or the amortization or maturity date may need to be extended. If the investors appear supportive and the revised plan is credible to the lender, the lender may agree to reset certain terms to provide additional flexibility to the borrower. However, the lender may also require adjustments to other terms (or add new ones) to protect its position. For example, the lender may include the following in any such an amendment to the credit facility: covenants that track success at implementing the revised plan; terms that shore up the collateral (e.g., add a lien on intellectual property or join material subsidiaries previously excluded from the credit structure); increased pricing; or additional fees. The lender will want to ensure that if the company is not successful at implementing the revised plan, the lender has a basis for a default and can step in to take a more active role without liability.

If all else fails, the lender's last-resort remedy is usually to conduct a foreclosure sale. The lender may already know a potential buyer for the business (perhaps an existing strategic partner or a company previously in negotiations with the company to acquire the business). As a secured party, it may sell the assets in a foreclosure sale after giving notice to the company and any other secured parties of record. The sale price, however, likely will be significantly less than what the assets could realize in a sale by the company.

If there is an offer to buy the company at a price that would repay the secured debt but require the investors to take a loss, there may be some push and pull between lenders and investors. The lender would prefer for the company to proceed with the sale to pay off the debt, but the investors may prefer for the company to work on turning the business around or look for a better deal. With adequate assurances of investor support, lenders are usually willing to allow some reasonable period to explore options. Lenders, investors and management are repeat players in the world of emerging companies, and in a downside scenario, relationships between the parties and reputational considerations will often influence decisions. In most cases, lenders resort to secured party remedies only when the relationships completely break down.

Introduction to in-court options for venture-backed companies

Concurrent with lender negotiations, a company may find itself considering obtaining relief under the U.S. Bankruptcy Code (the "Code"). For reasons described below, only a small fraction of venture-backed companies eventually pursue an in-court bankruptcy process.

Circumstances under which a bankruptcy process may be preferable for a venture-backed company

Chapter 7, Chapter 11 and Subchapter V

If a venture-backed company is evaluating its in-court options, it first must decide whether to file under Chapter 7, Chapter 11, or Subchapter V under Chapter 11 of the Code. A summary of each of these is below:

— **Chapter 7:** A Chapter 7 bankruptcy allows a debtor, through a court-appointed trustee, to liquidate its assets and distribute the proceeds to creditors by the priorities outlined in the Code. In contrast to a foreclosure, a sale of assets through a Chapter 7 bankruptcy is free and clear of all liens, claims and liabilities.

— **Chapter 11:** A Chapter 11 bankruptcy allows management to stay in control, with the debtor remaining in possession of the estate. The company can use bankruptcy either to liquidate assets, including a going-concern sale, or to reorganize through a Chapter 11 plan. Chapter 11 also provides a forum for creditors and other stakeholders to negotiate the terms of that sale or plan. A Chapter 11 bankruptcy provides a distressed company with a variety of options to meet its unique challenges, either through a court-supervised liquidation or a balance sheet restructuring and reorganization of the company. A Chapter 11 filing will make sense only if the company has enough liquidity to cover the administrative costs of Chapter 11, which can be an expensive process. Chapter 11 (and the Subchapter V alternative discussed below) provides the only method for a company to emerge as a going-concern business with a fresh start, free and clear of pre-filing liabilities.

— **Subchapter V:** Subchapter V became part of the Code in 2020 to allow small business debtors (i.e., companies with $7.5 million or less of non-insider liabilities as of the time of writing) to access many of the benefits of the Chapter 11 process but with streamlined procedures and at a lower cost. Most notably, this subchapter may be particularly attractive to startup companies because it eliminates the absolute priority rule for qualifying small businesses, allowing equity holders to retain value (and their ownership interests) even if creditors are not paid in full. In addition, Subchapter V debtors are freed from paying U.S. Trustee fees, the burden of an official creditors' committee and associated fees as well as the often costly disclosure statement process.

Benefits of a bankruptcy process

Through a filing under any of these chapters, the debtor is provided certain key benefits, including: a breathing spell through the imposition of the automatic stay over the debtor's estate to prevent creditors from pursuing their claims, a court-supervised process for the orderly distribution of assets and repayment of liabilities and a discharge of its pre-petition debts upon emergence. Such benefits may be attractive to a venture-backed company, for instance, if there are numerous or nonconsenting lender groups or the company faces litigation (or threats) that, absent the automatic stay, would detract from the company's resources and require management's attention.

Under each of these chapters, the company would be able to obtain finality through a discharge of its debts upon emergence from bankruptcy, and a sale of assets through the bankruptcy process is "free and clear" of all liens, claims and liabilities. In particular, a Chapter 11 filing could make sense for a venture-backed company in the following scenarios:

(a) A company with numerous parties-in-interest with competing interests and such parties cannot agree on the appropriate path forward (e.g., a debtor may utilize the court-supervised process to negotiate a "cramdown" plan over dissenting creditors);

(b) The sale of the company as a going concern will generate more value than a piecemeal liquidation of assets (e.g., certain technology or intellectual property may retain higher value if the developing engineers transition to the buyer or if those assets are packaged with the existing business infrastructure);

(c) A company seeks to shed burdensome obligations, (e.g., the ability to reject unexpired leases or cap landlord liabilities under Section 365 of the Code); and

(d) A company is facing complex or numerous pending or prospective litigation, including allegations of fraud against management or breaches of fiduciary duties against its directors and officers, and lenders are reluctant to lend because of these potential liabilities.

Common considerations in a bankruptcy proceeding

A venture-backed company that chooses a court-scrutinized bankruptcy process will likely face unique challenges.

Liquidity constraints

As with any insolvent company, the company will need some form of additional financing to meet its liquidity constraints, whether by soliciting capital from new investors or obtaining rescue financing from existing investors. If the company has secured debt in place, the most likely provider will be the existing lender. In a Chapter 11 reorganization — where transaction costs involve hiring restructuring professionals, filing necessary pleadings, providing notice to creditors and paying administrative expenses — the need to have sufficient liquidity is augmented, particularly if there is still a going-concern business where employees and other expenses also need to be paid. Given the exigent circumstances, the terms of debtor-in-possession financing used to finance a Chapter 11 case are usually lender-friendly.

Valuation

In the case of a reorganization of the company, a valuation may be required to confirm a Chapter 11 plan and determine the highest and best use of a company. For example, a valuation may be necessary to determine the value of secured creditors' liens to ensure they are adequately protected during the bankruptcy process or to establish the feasibility of a reorganization plan. When valuing a distressed company without positive cash flow, other operating or balance-sheet metrics may be considered (e.g., projections, soft assets like intellectual property, or industry-specific items), rather than more traditional valuation methodologies. Arriving at an accurate and defensible valuation of a venture-backed company will require careful consideration and valuation may be contested by dissenting creditors.

Capital structure and treatment of equity interests

Venture-backed companies often do not have secured debt, and instead, raise capital through equity investments. Under the Code's priority scheme, equity holders have the lowest priority and will receive a distribution (or be entitled to retain their equity) under a plan only if every other creditor class has been paid in full (except in Subchapter V where the absolute priority rule does not apply). Existing equity holders may end up with little to no recovery in the bankruptcy or may have their equity interests diluted or eliminated. If such equity holders do not consent to the debtor's plan and raise objections to the plan or other management decisions during the bankruptcy case, such objections could render the plan unconfirmable or otherwise raise transaction costs throughout the bankruptcy case.

Management specific issues

Typically, management and employees of venture-backed companies receive voting or nonvoting stock. A lack of majority or supermajority of equity holders who control the voting shares could become a roadblock to a successful restructuring if there is no consensus among constituent groups on the best strategic path forward, especially because certain equity holders' consent may be necessary to initiate the in-court bankruptcy process.

When approaching insolvency, the company's directors will need to be mindful of their fiduciary duties. Additional restructuring professionals (e.g., an independent director or a chief restructuring officer), may need to be appointed to the board to balance the insiders' views.

Assignment for the benefit of creditors

If an in-court restructuring is not the right fit for a venture-backed company, various alternatives are available that may be less expensive and time-intensive. Most notably, venture-backed companies may want to consider utilizing an assignment for the benefit of creditors.

One of the most efficient ways to wind down a company is through an assignment for the benefit of creditors ("ABC"). This approach is usually recommended for a company that is free of significant legal problems or disputes that would require court oversight and protection of the automatic stay. An ABC is a common law remedy (and codified by state statute in approximately 35 states, including California, Delaware and New York), through which a third-party assignee liquidates the company's assets and distributes the proceeds to the company's creditors. The specific methods and procedures of an ABC vary from state to state.

In a typical ABC, a company (the assignor) executes an assignment agreement with a third-party assignee (usually a restructuring expert), who then holds title, custody and control of the company's assets. The assignee provides creditors with notice of the ABC and will typically set a bar date for filing claims. The assignee acts as a fiduciary for all creditors and works to maximize value for the company's creditors. In doing so, it may sell assets through a public or private sale of substantially all assets as a going concern or liquidate assets piecemeal. Once the assets have been liquidated and claims have been reconciled, proceeds are distributed to creditors.

An ABC stands out as the main alternative to an in-court filing for venture-backed companies primarily because of its efficiency and significantly lower costs: in certain circumstances, an asset sale through an ABC can be effectuated as quickly as 30–45 days, with the full process of reconciling claims and making distributions to creditors concluding in the months thereafter.

Conclusion

For venture-backed companies facing financial distress, there are several key considerations in negotiating with lenders or, as the last resort, in-court options. Because of their typically unique features, financially distressed venture-backed companies will need to carefully consider their strategic alternatives in choosing a path forward, keeping in mind fiduciary obligations to shareholders (and to creditors, if insolvent). This may include taking advantage of the in-court bankruptcy process or an ABC to preserve and maximize the value of the business or assets.

19 D&O INSURANCE AND FIDUCIARY DUTIES: A LESSON IN PROTECTING THE DIRECTORS AND OFFICERS DURING A RESTRUCTURING

LEGAL & INSURANCE PERSPECTIVE

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As a company heads down the restructuring path, its directors' and officers' fiduciary duties shift from the company's shareholders to both its shareholders and creditors. When exactly this shift occurs is the tricky part, creating liability minefields the directors and officers must try to avoid. Making matters worse, as a company's financial situation deteriorates, the personal asset risk of the directors and officers increases at the exact same time that the company can no longer indemnify them.

Certainly, there are processes the directors and officers can follow to mitigate the risk of being second-guessed, but the risk of being sued can never be eliminated. Enter Directors' & Officers' Liability ("D&O") insurance. While D&O insurance is designed to protect both the individuals' personal assets and the company's balance sheet, during a restructuring, the personal asset protection becomes the primary focus. The question is: how does a company put its D&O policy in the best position to protect its directors and officers during a restructuring?

D&O fiduciary duties and indemnification in a restructuring

Under ordinary circumstances, the directors and officers of a solvent company owe fiduciary duties to the company and its shareholders. In contrast, when a company is insolvent, the constituency to which directors and officers owe fiduciary duties shifts to include creditors. Accordingly, insolvency does not create new fiduciary duties, it merely adds beneficiaries to the directors' and officers' existing duties and affords creditors the right to bring derivative claims for breaches of fiduciary duty.

Determining when a company becomes insolvent or approaches the "zone of insolvency," however, is anything but simple. Insolvency is alternatively defined as where a company's liabilities exceed its assets ("balance sheet insolvency") or where it cannot generally pay its debts as they become due ("equitable insolvency"). This latter type of insolvency is typically defined as when the board is considering transactions that can render it insolvent. Thus, insolvency determinations are fact-based inquiries that vary from state to state.

Regardless of the test used, directors and officers must be aware of the impact insolvency can have on their personal liability. While directors and officers are ordinarily indemnified from certain liabilities by the company, an insolvent company likely lacks the means to fund its indemnification obligations which makes insurance even more important. Additionally, as described in greater detail below, the filing of a bankruptcy petition results in a legally enforceable "stay" on any litigation against the debtor company but often not against directors and officers. This lack of protection results in increased director and officer litigation exposure and demonstrates the high value D&O insurance can provide to directors and officers of an insolvent or near-insolvent company.

A primer on D&O liability insurance

D&O insurance protects the company, its directors and officers against securities law violations, breach of fiduciary duty, fraud and similar claims. D&O insurance actually serves as a back-stop for the directors' and officers' personal assets when indemnification is not available. ***So, in a restructuring scenario, the policy must work.*** But before you can ensure the D&O insurance responds, you must understand the basic construction of a D&O program.

Traditional D&O policies include three insuring agreements: Sides A, B and C, which are all subject to a shared, single aggregate limit, illustrated in Exhibit 13. Side A is personal asset protection and

EXHIBIT 13. Illustration of D&O insuring agreements and program construction.

is the most important coverage heading into a restructuring. It covers insured persons in situations where indemnification is not provided or available (such as when the company is insolvent). Side B is balance sheet protection, and it reimburses the company for indemnification provided to insured persons. Side C is also balance sheet protection, and it covers the company when the company is named in a covered claim.

Many companies choose to also purchase dedicated Side A-only coverage with a difference in conditions ("DIC") feature. Side A DIC limits are only available to the individuals — they are not shared with the company — and they can "drop down" in certain situations; e.g., more restrictive Side A terms in the underlying policy or financial insolvency of an underlying insurer, to provide first dollar coverage for the directors and officers.

D&O policies are generally written on a claims made and reported basis, meaning that coverage must be in place at the time the claim is received in order for the insurance to respond. That is why companies purchase an extended reporting period (also commonly referred to as "runoff" or a "tail") in connection with the restructuring. A D&O tail extends the time for insureds to submit claims arising from wrongful acts that are alleged to have occurred prior to the restructuring change of control date, but that are asserted after the change of control date.

Best practices with respect to D&O insurance heading into a restructuring

Financial distress and bankruptcy create heightened personal asset risk and litigation exposure for directors and officers. Couple that with the company's inability to indemnify its directors and officers, and it's easy to understand why the D&O policy must work. But what steps should a company take to put its D&O policy in the best position to respond in a restructuring scenario?

Bankruptcy diagnostic

Bankruptcy counsel and a restructuring-focused broker should review any existing D&O policies to identify (and remediate) any gaps in coverage that create exposure for directors and officers.

D&O policies are not standardized from a language perspective, and unique bankruptcy claim scenarios may not be contemplated by an "off-the-shelf" policy. Therefore, significant amendments are needed to shift contractual leverage from the insurer to the insured and to allow the insurance to respond as intended, especially for a distressed claim scenario. Put simply: if the D&O policy is not drafted properly, gaps in the coverage could exist and certain claims may not be covered.

Common examples of material deficiencies in a D&O policy that a bankruptcy diagnostic can expose

Insured vs. Insured exclusion

The Insured vs. Insured ("IvI") exclusion (or Entity vs. Insured exclusion) is a standard clause in D&O policies and precludes coverage for claims by one insured against another insured. The IvI exclusion, however, can cause unintended complications when the insured company files for bankruptcy because of all the additional bankruptcy-specific parties that can bring actions on behalf of the estate. For instance, if the newly formed Creditors' Committee brings an action on behalf of the debtor company against the directors, that could be considered a claim by (or on behalf of) an insured party against another insured party, thereby triggering the IvI exclusion under the D&O policy and forcing the defendant directors to come out of their own pocket to defend the action and pay any settlement or judgment.

As a result, it is important that the IvI exclusion contains a broad carve-back for claims brought by the debtor-in-possession, the Creditors' Committee, bankruptcy trustees and similar parties.

Bankruptcy/insolvency/creditor exclusions

Some of the most egregious coverage errors in D&O policies are bankruptcy/insolvency/creditor exclusions. They are usually each a separate exclusion and policies can contain one, two or all three of them. These exclusions are exactly as bad as they sound. A bankruptcy exclusion precludes any claims relating to a bankruptcy:

The insurer shall not be liable for Loss in connection with a Claim based upon, arising out of, or in any way related to the bankruptcy of the Named Insured or any subsidiary.

An insolvency exclusion precludes any claims relating to the company's insolvency:

The Insurer shall not be liable for Loss in connection with a Claim based upon, arising out of, or in any way related to the financial insolvency or impairment of the Named Insured or any Subsidiary.

A creditor exclusion prohibits any claims brought by a creditor of the company:

The Insurer shall not be liable for Loss in connection with a Claim brought by or on behalf of a creditor of the Named Insured or any Subsidiary.

Any of these exclusions will gut the coverage offered by a D&O policy for a company heading toward a restructuring and should be an absolute non-starter when placing or renewing D&O coverage.

Knowledge exclusion

Unlike the bankruptcy/insolvency/creditor exclusions, the knowledge exclusion is much more subtle. In fact, it is actually sold to unsuspecting brokers as a coverage enhancement, but in reality, it creates additional possibilities for carriers to deny a claim.

Under state law, D&O policies are rescindable if there has been a material misrepresentation in the application process. But in order to do so, the insurer must carry a burdensome legal standard. As a result, in recent years, carriers have been agreeing to make the policies fully non-rescindable in exchange for language that excludes claims relating to a material misrepresentation:

If there is any misrepresentation or omission in the Application, **this policy shall not afford coverage for**:

a. *any Insured Person under Insuring Agreement A*

b. *the Named Insured under Insuring Agreement B*

c. *the Named Insured or any Subsidiary under Insuring Agreement C*

The Insurer shall not seek to rescind this policy for any reason.

The problem with this trade for the insured is that now, instead of the carrier having to prove in-court a material misrepresentation occurred, the carrier can simply determine, unilaterally, that there was a material misrepresentation and deny the claim. In which case, the burden is now on the insured to prove a negative — that no material misrepresentation occurred — while legal bills pile up defending the claim.

The much more advantageous coverage language for the insured is to have strong severability language and a policy which is non-rescindable for Side A coverage only.

Improving and amending D&O policy definitions prior to a restructuring

The company, with the assistance of its bankruptcy advisors, should also assess whether certain existing D&O policy definitions, which operate properly in non-distressed scenarios, should be amended or improved to better suit distressed contexts. Indeed, certain D&O policy definitions pre-bankruptcy may directly hinder the goals of the restructuring process. For example, it is imperative that the definition of the "insured" under the D&O policy covers the debtor-in-possession. This is because a company filing for bankruptcy protection becomes a debtor-in-possession, a legally cognizable and separate entity from the company pre-bankruptcy. An "insured" definition that does not cover potential debtors-in-possession would completely limit the protection afforded by a D&O policy.

Along similar lines, many D&O policies include a "change of control" date that cuts off insurance protection for acts committed after the date arises. Therefore, the definition of change of control is of critical importance. Some D&O policies could include in the change of control definition, for example, the appointment of a receiver, liquidator, trustee or other similar appointee. The concern in bankruptcy is that directors and officers frequently act on behalf of the debtor-in-possession post-bankruptcy filing even after such an appointment. Accordingly, a company considering a bankruptcy petition may need to renegotiate the scope of the change of control provisions.

While the above covers just two common examples, it is vital that near insolvent companies consider how other ordinary D&O policy terms may similarly frustrate the bankruptcy process. As such, assistance from D&O insurance experts to negotiate improvements to a D&O policy may prove critical in avoiding coverage gaps when filing for bankruptcy protection.

Bind and pre-fund the D&O runoff prior to the bankruptcy filing

An extended reporting period is necessary to allow the insureds to notice claims, throughout the statute of limitations period, arising out of wrongful acts that are alleged to have occurred prior to the end of the bankruptcy process. But when should the runoff be purchased?

Absent a reason not to do so, it is recommended that the tail be bound and paid for prior to the bankruptcy filing. First, a company is generally in control of its own finances prior to a filing. After the bankruptcy petition date, purchasing the runoff will likely require Bankruptcy Court approval, which could invite objections from creditors asking why the company is spending estate assets on something that appears to only benefit the directors and officers.

Second, the negotiation for runoff coverage is likely the last opportunity to remediate coverage deficiencies within the D&O program. If a company is able to improve policy language in conjunction with the runoff placement, any coverage enhancements will be effective at the time of binding the tail. So, if the runoff is bound pre-filing and a claim is asserted on day one of the bankruptcy case, the new-and-improved D&O policy language will apply to that claim (as opposed to the previous policy language containing the gaps in coverage).

Extend the policy through the restructuring matter

It is critical that directors and officers maintain D&O coverage throughout the bankruptcy and any wind-down process — that means until the last director or officer shuts off the lights to the debtor's estate. If the policy expires prior to the end of the bankruptcy process or the extended reporting period is triggered at the close of a 363 sale, the directors and officers are left with winding-down the remaining estate without D&O coverage, and oftentimes they don't know it.

The best defense against losing coverage is to approach the carriers about extending the D&O program through the expected length of the bankruptcy matter (with the ability to further extend, if necessary) at the same time as negotiating the runoff, i.e., prior to the bankruptcy filing.

Purchase additional limits

D&O policies provide a single, shared limit for all claims (those against the entity and the individuals) that are noticed during the policy period. Meaning that in a restructuring, one limit may need to cover claims made over a period of seven years or more. In light of that, prior to the bankruptcy filing, the company should also consider whether their limits are adequate. This is especially relevant when:

— A company historically under-purchased D&O limits because it is a closely held company and didn't believe the risk justified higher (or appropriate) limits.

— A company recently reduced its limits because the cost of D&O insurance has increased significantly.

— A company has noticed claims to the existing D&O insurance program and their limits are now impaired.

— New independent directors or new interim officers are joining the company to assist with the restructuring, and they require their own limits.

— New directors or officers are brought into a situation where there are allegations of fraud, and they're concerned that the alleged bad actors will erode most or all of the existing limits.

In any of these situations, there is an opportunity to increase the D&O limits prior to the restructuring. The insured persons will likely, however, be required to execute a warranty statement for the new limits asserting they do not have knowledge of any facts or circumstances which would reasonably be expected to give rise to a loss under the new coverage.

D&O policies as property of the estate and interactions with the automatic stay

After grasping the nuances of D&O policy terms, it is also vital that directors and officers understand how D&O policies, including their applicable proceeds, will be treated by the Bankruptcy Court and how such treatment impacts liability coverage. Section 362(a)(3) of the Bankruptcy Code automatically stays all entities from obtaining possession of or exercising control over property of the bankruptcy estate. Moreover, pursuant to Section 541(a)(1) of the Bankruptcy Code, property of the bankruptcy estate includes all legal or equitable interests of the debtors in property as of the commencement of the bankruptcy case. Accordingly, if D&O policies and their proceeds are viewed by the Bankruptcy Court as property of the estate, the automatic stay prevents directors and officers from accessing D&O policy proceeds and subjects them to litigation exposure.

Courts today generally hold that the D&O insurance policy itself is property of the bankruptcy estate. However, whether the proceeds of such a policy are property of the estate often turns on whether the policy proceeds are designed to, and will, benefit the debtor or the debtor's directors and officers. For example, proceeds of a policy with only Side A coverage are unlikely to be viewed as estate property since the proceeds only benefit individual directors and officers. Similarly, proceeds of Side B coverage, which only reimburse the debtor for indemnification provided to insured persons, are often not viewed as estate property because Side B coverage merely provides indirect indemnification for directors and officers. In contrast, Side C coverage, which provides entity level liability protection, directly benefits the debtor and the proceeds of such coverage are often viewed as estate property.

Most frequently, D&O policies include Sides A, B and C coverage under a shared, single aggregate limit and the proceeds of such policies are considered estate property even if portions of the policy are for the benefit of directors and officers. However, practical considerations may lead a Bankruptcy Court to view the proceeds of such policies as non-estate property. For example, the proceeds of a policy including Sides A, B and C coverage for a debtor that has already extinguished all or nearly all direct liability claims may not be viewed as estate property. The rationale here is that, in practice, any proceeds resulting from such a policy are unlikely, at that point in time, to benefit the debtor as no claims against the debtor remain. This demonstrates how the facts of each individual case can alter a Bankruptcy Court's proceeds/benefits analysis as the practical use of a D&O policy will differ in each bankruptcy case.

To avoid leaving director and officer liability exposure risk in the hands of the Bankruptcy Court, companies can take certain proactive measures to isolate policy proceeds for the benefit of directors and officers. For example, a company could purchase dedicated Side A DIC coverage whose proceeds are only available to directors and officers, and accordingly, sit outside the bankruptcy estate. Moreover, the previously described DIC feature also functions to protect directors and officers from the risk that a primary policy is unavailable during bankruptcy. Alternatively, if additional dedicated Side A coverage is cost prohibitive, a company could negotiate a Side A payment priority term in the main policy, in which any proceeds are paid first to directors and officers and then to the company. This kind of policy term, by ensuring that a portion of the policy proceeds must be provided to directors and officers, increases the probability that the Bankruptcy Court views such proceeds as non-estate property.

Conclusion

The foregoing demonstrates the value D&O insurance provides during a complex restructuring.

Each individual provision and definition must be carefully scrutinized and scenario tested against a hypothetical restructuring backdrop in which indemnification funds are inaccessible or otherwise nonexistent. With the proper advisors in place, companies and their personnel should feel confident that they can enter and emerge from bankruptcy protected from liability exposure.

20 TRUST FUND TAXES: AVOIDING PERSONAL LIABILITY FOR DIRECTORS AND OFFICERS IN DISTRESSED SITUATIONS

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When a business experiences an acute cash flow shortfall and is unable to access conventional sources for additional financing, directors and officers of the company are presented with difficult choices. Preserving the value of the business for all stakeholders is critical, and directors and officers, quite rightly, will exhaust all available avenues to unlock liquidity to maintain operations and preserve the business. It may be tempting for directors and officers to use funds designated for another purpose to cover essential operating expenses in the short term, expecting that those funds may be replaced once additional revenues are generated. The impulse to preserve the business at all costs, however, must be checked against the legal and fiduciary realities that directors and officers face.

This is particularly true with respect to a company's "trust fund taxes," which consist of funds that are withheld or collected by the company, in trust, for the benefit of applicable taxing authorities. These funds are typically collected in the ordinary course of business, but are often not paid until future dates, typically on a quarterly basis. Accordingly, these funds might seem like a useful short-term, low-cost financing tool to meet immediate operational needs, but if future revenue forecasts are inaccurate and anticipated revenues fail to materialize within the expected time frame, the result could be significant tax delinquency, potential penalties, or worse, personal or criminal liability for directors and officers (as well as other responsible employees). It is essential, therefore, that directors and officers have a sound understanding of trust fund tax liabilities and ensure that the company is collecting and paying all such tax obligations, including in connection with a bankruptcy filing of the company.

Trust fund taxes and the trust fund recovery penalty

The phrase "trust fund taxes" encompasses a number of obligations that a company may owe to federal, state and local taxing authorities when, pursuant to statutory requirements, the company receives the funds in question and holds them in trust for the taxing authority. Common forms of trust fund taxes include certain withholdings from an employee's wages, sales taxes collected at the point of sale and excise taxes that are required to be collected in connection with activities as diverse as the sale of coal mined from specific regions to the provision of indoor tanning services.

Trust fund taxes can vary based on state and local laws as well as the type of business conducted by the company. Directors and officers should consult with tax and legal advisors to understand fully the company's actual trust fund tax obligations, including all trust fund taxes that are collected or held by the company prior to payment to the taxing authority. Because the general principles concerning officer and director liability for misappropriation of trust fund taxes are largely similar regardless of the specific type of trust fund tax at issue, a full discussion of all possible trust fund tax liabilities will not be addressed within this chapter. Instead, this discussion will focus primarily on the federal trust fund taxes based upon withholdings from employee wages, which is applicable to every business that has employees.

Under the Internal Revenue Code (the "IRC"), employers are required to withhold amounts from employee wages for federal income taxes and the employee's share of Social Security and Medicare taxes. The IRC further requires that these withholdings be held by the employer in trust for the United States government. Pursuant to regulations issued by the U.S. Department of the Treasury, the amounts withheld from employee wages and held in trust by the company must be reported and paid to the government each quarter. There is no requirement for these funds to be held in a segregated account (e.g., they can be held in the employer's general operating account). Nevertheless, the withheld amounts are for the exclusive use of the government and are not to be used to pay the employer's expenses. If the trust fund taxes are not paid, the Internal Revenue Service ("IRS") has a number of tools for collecting the unpaid amount, including charging the company penalties of up to 25 percent of the amount of tax owing.

In addition to the collection efforts that the IRS may make against the company, the IRS may also seek collection of the full amount of unpaid trust fund taxes from any person found to be responsible for their payment, such as the company's officers and directors. This provision of the IRC is commonly referred to as the "trust fund recovery penalty." Despite its name, the trust fund recovery penalty is not technically a penalty but rather a collection device because it allows the IRS to collect the original amount of the unpaid trust fund tax (plus interest), not an additional penalty amount. While the company is, of course, responsible for the payment of its trust fund taxes, the taxing authority can choose to enforce the trust fund recovery penalty against directors and officers prior to attempting collection from the company.

Liability under the trust fund recovery penalty

In order to be found liable for a company's unpaid trust fund taxes, an individual must be found to be both a "responsible person" and to have acted "willfully" with respect to the nonpayment of the trust fund tax obligation. (IRC § 6672(a); *Slodov v. United States*, 1978). These terms have been the subject of substantial litigation and courts have developed criteria for determining when an individual is a "responsible person" and when the nonpayment of trust fund taxes is "willful" but, as described below, it will be difficult for directors and officers to avoid liability when a company fails to pay required trust fund taxes.

Generally, a "responsible person" is anyone who is required to collect, withhold (account for) or pay the trust fund taxes. Whether an individual is a responsible person is a very fact-intensive inquiry and can be the source of extensive and costly litigation, the costs of which could fall to the directors and officers. While the number of factors considered by various courts may differ, the substance of the analysis is largely the same and is focused on whether the individual (i) is an officer, director or shareholder of the company, (ii) is active in the day–to–day management of the company, (iii) makes decisions concerning the priority in which taxes and debts will be paid, (iv) has the ability to hire and fire employees, (v) has check signing authority and (vi) exercises control over accounts and disbursement records. These factors cover a wide range of potentially responsible parties, and directors and officers often are identified specifically by courts as meeting the criteria of a responsible person.

There are other factors that courts have used to expand the parties that can be a responsible person. For example, an individual needs only to have the authority to exercise control of the financial decisions of the company and is not required to actually exercise that power. This could directly expose directors and officers who have authority over certain matters but may not exercise that authority on a day–to–day basis, delegating such tasks to others. Further, exclusive control is not required, so the authority and decision making can be shared by multiple individuals. By contrast, individuals that perform purely ministerial acts that do not involve exercising independent judgment or control are not considered responsible persons for purposes of trust fund recovery penalty liability, although this exception will be of little use to anyone occupying a director or officer position.

To be liable for a trust fund recovery penalty, a responsible person's failure to collect, account for or pay the trust fund tax must also be willful. A merely negligent failure to pay trust fund taxes may be excusable. Willfulness is considered to be a voluntary, conscious, intentional act to prefer other creditors over the taxing authority, but willfulness does not require a showing of bad motives or an actual intent to defraud the government. Willfulness has also been established based upon an individual's reckless disregard for the payment of trust fund taxes where there was a grave risk that the taxes would not be paid, the taxpayer clearly should have known about the risk, and the taxpayer was in a position to find out for certain very easily.

There are two common situations where courts have found, as a matter of law, that funds were willfully misappropriated. The first is where other creditors of the company are paid with funds that are needed to pay the trust fund taxes. For example, a responsible person that elects to pay company employees their full net wages and then is unable to pay the applicable withholding taxes, would be liable for a willful misappropriation of the trust fund taxes. In such a circumstance, the wage claims of employees are treated as any other creditor of the business, and giving preference to those claims over the claims of the taxing authority is willful. Continuing with this example, suppose that a company has enough available cash to pay the full amount of net wages owing to its employees but, after doing so, would have insufficient funds to pay the required withholding taxes for the same pay period. In that case, to avoid liability for a willful misappropriation of the trust fund taxes, the company would have to reduce the amount of net wages that it pays to employees to a point where it can also pay the full amount of withholding taxes for the net wages that are actually remitted. Courts have upheld this principle even in cases where employees threaten to quit if they did not receive the full amount of net wages owed to them. The second situation where willful misappropriation may be found as a matter of law is where a responsible person becomes aware of a delinquency in the payment of trust fund taxes and subsequently permits the payment of other creditors ahead of the taxing authority. In such a situation, the responsible person must use all unencumbered funds (i.e., funds that are not subject to a security interest senior to the taxing authority that prevents payment of the delinquency) to satisfy the trust fund tax delinquency before paying other creditors.

A responsible person, under certain circumstances, may be excused for relying on false statements made by another person attesting that the trust fund taxes have been paid; however, directors and officers should take additional measures to verify such statements because relying on simple assertions of others, without more, is insufficient to avoid liability. In addition, a responsible person generally cannot assert a defense to a claim based on the fact that they were merely following the orders of their supervisor. Further, it is not an excuse that the company did not have sufficient funds to pay the taxes when due because the withheld amounts were used to pay other debts that were essential to maintain operations. Similarly, a taxpayer's claim that it expected the financial condition of the business to improve has been uniformly rejected as a defense to the willfulness of a responsible person that does not pay trust fund taxes. Simply put, an inability to pay is unlikely to be a successful defense, even if the motivation of the director or officer was to save the company for the benefit of all stakeholders.

In addition to the civil claims that may be brought to collect under the trust fund recovery penalty, in egregious cases failure to pay trust fund taxes may result in felony criminal prosecution. In statutory language that mirrors the responsible person and willfulness provisions of the trust fund recovery penalty, the IRC also provides for a fine of up to $10,000 and imprisonment for up to 5 years. (IRC § 7202).

Proper planning for trust fund taxes (in and out of bankruptcy)

In every scenario, it is critical for directors and officers to properly plan and prepare for payment of trust fund taxes. Further, in cases where a company becomes insolvent or is forced to file for bankruptcy protection, if appropriate procedures and safeguards are not put in place, a company's bankruptcy filing could increase the likelihood that directors and officers become subject to claims under the trust fund recovery penalty or similar statutes for unpaid trust fund taxes.

An example of how a company and its officers and directors could be liable for unpaid trust fund taxes may be helpful. Consider a situation where, faced with an acute cash flow shortfall, management used cash withheld from employee wages to cover immediate operating expenses with the expectation of replacing the funds with anticipated future revenues that never materialized and the company subsequently filed for bankruptcy. The unpaid trust fund taxes are now a pre-petition debt of the company and the IRS, like other creditors, is prohibited from attempting to collect the debt from the company because of the automatic stay that was put in place upon the filing of the company's bankruptcy petition. However, while the automatic stay prevents the IRS from taking action against the company, it does not prohibit the IRS from pursuing collection of the trust fund recovery penalty from the officers and directors (and any other responsible persons) of the company, and it is difficult to get court approval to extend the automatic stay to protect the company's officers and directors with respect to trust fund recovery penalty liability. In this scenario, pursuit of the trust fund recovery penalty against officers or directors who were responsible for the nonpayment of the trust fund taxes is likely the most appealing and least burdensome course of action for the IRS. Moreover, it is possible that any amounts that the company does pay to the IRS on account of delinquent taxes (e.g., through a Chapter 11 plan of reorganization) may first be applied to non–trust fund taxes and, therefore, will not reduce the liability of responsible persons under the trust fund recovery penalty.

This situation is entirely avoidable through careful planning and the implementation of some common sense safeguards. First, the company should consult with its tax and legal advisors to ensure that all relevant personnel have a complete understanding of the company's trust fund tax responsibilities at the federal, state and local levels. Second, the company should limit the number of individuals that can be considered responsible persons by designating the authority for the collection, accounting and payment of trust fund taxes to a small group of individuals. Third, the company should implement procedures to ensure that all applicable trust fund taxes are collected and paid at every applicable interval. In the event that the company faces a potential bankruptcy filing, it should coordinate with its legal and financial advisors concerning the timing of collection and payment of its trust fund taxes to ensure that no amounts are unpaid as of the bankruptcy filing date. Bankruptcy counsel will typically also prepare a motion to seek authority from the bankruptcy court to continue paying the company's tax obligations (including trust fund taxes) during the bankruptcy, and such motions are routinely approved.

Regardless of how strong the desire to preserve a distressed business may be, the legal and fiduciary requirements related to the collection and payment of a company's trust fund taxes are clear, and the potential liability for officers or directors that run afoul of those requirements is severe. By understanding the rules regarding trust fund taxes and taking appropriate measures to ensure compliance, officers and directors can avoid potential pitfalls while managing financial distress.

21 RELEASES IN OUT-OF-COURT AND IN-COURT RESTRUCTURINGS

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Restructurings present complex and fact intensive financial and legal issues that must be evaluated on a case-by-case basis. Releases generally play a key role in a restructuring. A release is a "jural act of high significance without which the settlement of disputes would be rendered all but impossible." *Berman v. Parco*, 986 F.Supp. 195, 208 (S.D.N.Y. 1997).

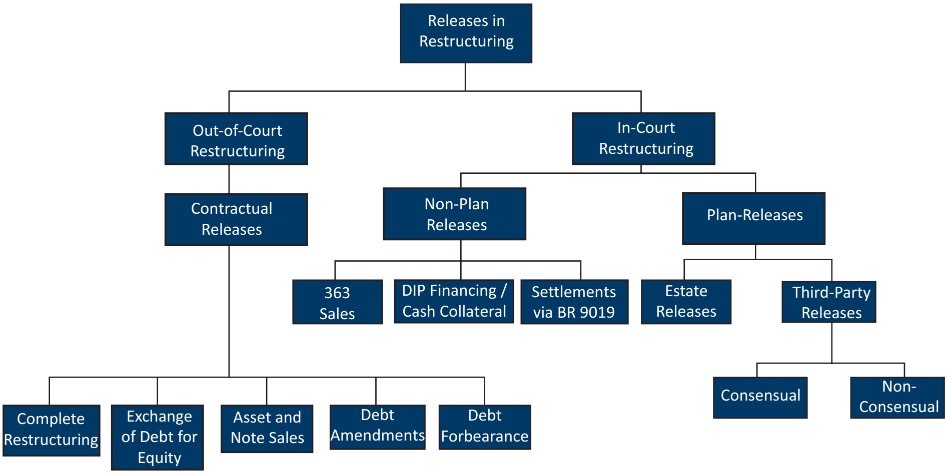
The use of releases by the parties in a restructuring can help provide certainty and resolution, enabling the parties to turn the page and move on from a period of financial challenges. Releases of claims and causes of action are often heavily negotiated in restructurings, whether in- or out-of-court. Companies generally seek a fresh start and aim to avoid future indemnity claims and are therefore open to granting releases as appropriate to their key stakeholders (if appropriate under the circumstances). Relevant stakeholders in a restructuring — including the company, agents/indenture trustees, lenders, unsecured creditors, private equity sponsors and the company's officers and directors — may seek releases when a company undergoes a restructuring in order to achieve their goals.

Restructurings that include potential releases by third parties over their objection can present more complex issues; there is no consistency regarding allowance and limitations on such third-party releases. This is an area of extensive current debate, including within Congress.

It is key for companies, directors and officers to analyze and conduct diligence as to potential claims and causes of action in determining the appropriateness of releases and the extent of any valuable claims. Appropriately drafted releases should protect the released parties broadly, including from contract, tort and common law and equitable and statutory claims that might be asserted against the released party.

This chapter will first provide a general overview of releases that are granted as part of a restructuring process, which can occur via out-of-court or in-court restructurings. It will then provide an overview of important considerations for key stakeholders involved in

EXHIBIT 14. Releases in restructuring



Abbreviations: DIP-Debtor-in-Possession; BR-Bankruptcy Rule; 363 Sales-Sales Pursuant to Section 363 of the Bankruptcy Code.

the restructuring process and in deciding whether to grant releases. An overview of the general structure and issues regarding restructuring releases is illustrated in Exhibit 14.

Overview of releases

Releases obtained via an out-of-court restructuring process

Granting releases is often a key component to any out-of-court restructuring, whether a comprehensive restructuring, exchange, sale, workout, forbearance or loan amendment, and it will often take the form of a mutual, contractual release between parties. A distressed company and the company's key stakeholders will generally provide a broad release of claims and causes of action that might otherwise be asserted against the released parties in exchange for a forbearance or waiver of the exercise of rights and remedies, amendment of credit documents, exchange of debt for equity or other negotiated forms of consideration to support the out-of-court debt restructuring.

Out-of-court releases are contractual in nature and will not expand beyond the contractual terms between the releasing and released parties. Such releases are customarily required for all parties to voluntarily support a significant financial restructuring transaction.

Releasing parties must evaluate the costs and benefits associated with providing a release as part of the consensual, out-of-court transaction. The form of the release agreement is typically extensively negotiated and may release a broader set of claims than a release that is subject to court approval.

Courts will generally enforce releases granted in an out-of-court workout, forbearance or amendment, as the releases provide an incentive for parties to resolve the relevant issues and create a comprehensive, out-of-court solution. While out-of-court releases are potentially not as expansive to third parties as in-court releases, they are not subject to potential objections by other parties and bankruptcy court approval.

Releases obtained via an in-court restructuring process

In most Chapter 11 plans, estate and third-party releases are a highly negotiated point because certain parties may want the process finalized with the comfort that claims and causes of action will not be brought against them in the future while others want to preserve claims and causes of action that they view as valuable.

Releases via an in-court restructuring are most commonly implemented pursuant to a Chapter 11 plan. However, releases via an in-court process can also be granted in a sale process under Section 363 of the Bankruptcy Code, an order approving debtor-in-possession financing, or in a settlement under Bankruptcy Rule 9019. In-court releases can be broader in effect than releases received outside of Chapter 11; the bankruptcy court approval of such releases may bind third parties even if they are not a contractual party executing the release. This result is appropriate because all parties will have notice of the releases and the ability to object and oppose the releases. These releases give the debtors a fresh start, which is a key policy of the Bankruptcy Code.

Releases obtained via an in-court restructuring process may come at a significant cost given the (1) potential impact on the debtor and its business, (2) professional fees and other costs associated with a Chapter 11 case and (3) potential contribution required from a party receiving a release, which may be a condition for the court to approve such a release. Therefore, as with out-of-court transactions, parties must evaluate the costs and benefits associated with providing a release in an in-court restructuring.

A Chapter 11 plan may also include an injunction and broad retention of jurisdiction provision that will channel hypothetical claims against a third party receiving a release into the bankruptcy court to the maximum extent permitted by law. This can enhance certainty for released parties as to the effectiveness of the release. While a company receives its protections via the plan discharge and injunction, releases as to a third party — such as a director or officer, lender or sponsor — will take two forms: (1) releases of third parties by the debtors and their estates (“estate releases”) and (2) releases of third parties by other non-debtor third parties (“third-party releases”).

Estate releases

When a Chapter 11 case is filed, a company’s property (subject to certain limited exceptions) automatically becomes the property of its bankruptcy estate. Section 541 of the Bankruptcy Code broadly defines property of the estate as “all legal and equitable interests of the debtor in property as of the commencement of the case” and includes a debtor’s claims and causes of action. State law determines whether property, such as a cause of action, belongs to a debtor prior to filing for relief under Chapter 11. As a result, once a company files for Chapter 11, any pre-petition action that belonged to the company becomes property of its bankruptcy estate, and the debtor has the exclusive right to prosecute, settle and release any such action.

The types of actions that a debtor may prosecute, settle and release are “[a]ctions that belong to the estate” and “[a]ctions by individual creditors asserting a generalized injury to the debtor’s estate, which ultimately affects all creditors,” also referred to as “derivative claims.” *Schimmelpenninck v. Byrne (In re Schimmelpenninck)*, 183 F.3d 347, 360 (*5th* Cir. 1999).

“Derivative claims” of the estate are in contrast to “direct” claims of particular creditors for a direct injury to such creditors. “Direct claims” do not constitute estate causes of action, and therefore are not eligible for inclusion in an Estate Release. Numerous causes of action often associated with creditors’ remedies outside of Chapter 11, such as veil-piercing and other so-called “derivative” or “general” claims, have been held and are generally accepted to be property of a debtor’s bankruptcy estate.

The following causes of action are generally eligible to be included in estate releases:

(1) alter ego, single-business-enterprise and other veil-piercing claims;

(2) lender-liability claims;

(3) successor liability claims;

(4) fraudulent-transfer and preference claims;

(5) breach-of-fiduciary-duty claims; and

(6) agency/joint-venture claims.

With court approval, a company in Chapter 11 can release estate “derivative claims.”

Obtaining estate releases is often critical to third parties such as officers and directors, lenders, private equity sponsors and other interested parties because they provide assurance that such claims will not be prosecuted by the company or its successors (including a litigation trustee). Therefore, estate releases are frequently used as incentive for parties to support a consensual, in-court restructuring.

Third-party releases

Section 1141 of the Bankruptcy Code grants a company in Chapter 11 a fresh start via a discharge of its pre-petition liabilities. However, this discharge is limited to debtors, and Section 524(e) of the Bankruptcy Code specifically states that the discharge does not affect the liability of non-debtor third parties. While there is not uniformity in the court system regarding third-party releases, parties have used Chapter 11 plans to obtain third-party releases, which can be necessary to obtain parties' cooperation and consensual economic commitment in an in-court restructuring and Chapter 11 plan.

Third-party releases are often expansive and can be broad enough to release all claims and causes of action held by any non-debtor third parties against other non-debtor third parties. For instance, a third-party release may include a release of (1) a shareholder's direct claim against members of management or the board of directors or (2) a general unsecured creditor's claim against a private equity sponsor. Such releases can be a valuable restructuring tool because they can prevent extended litigation and incentivize parties to participate in a restructuring transaction.

While obtaining third-party releases may be key to pursuing an in-court restructuring in some instances, such as mass tort cases, third-party releases are not always the core focus of every in-court restructuring. For example, in a pre-packaged bankruptcy case, the key focus may be to accomplish a quick in-court process to effectuate a balance sheet restructuring.

Third-party releases can take two different forms: (1) consensual and (2) non-consensual.

It is largely accepted that a Chapter 11 plan can include third-party releases if the releases are consensual. *See* Collier on Bankruptcy ¶ 524.05 (16th ed. 2020). Given the disparate outcomes that can occur if a third-party release is deemed consensual versus non-consensual, how a party expresses consent is an important consideration for courts across jurisdictions.

- Some courts have determined that a party has only consented to a third-party release when they do not "opt-out" of a third-party release, or they have affirmatively "opted-in" to a third-party release. *See In re Abeinsa Holding, Inc.*, 562 B.R. 265, 285 (Bankr. D. Del. 2016); *In re Washington Mutual, Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011); *see generally Talarico v. Ultra Petroleum Corp.*, 2020 WL 8361996 at 1 (S.D.T.X. Dec. 29, 2020).
- Other courts have determined that parties that are unimpaired and therefore not entitled to vote on the plan can be deemed to consent to third-party releases without the opportunity to opt-out. *See In re Indianapolis Down, LLC*, 486 B.R. 286, 304-05 (Bankr. D. Del. 2013).

A majority of circuit courts have also found authorization to grant non-consensual third-party releases through the broad equitable powers under Section 105(a) of the Bankruptcy Code, which allows the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."

- While these courts permit non-consensual third-party releases, special or exceptional circumstances must exist before such a powerful release is granted. *See* Collier on Bankruptcy (16th 2021)*; see generally In re AOV Indus. Inc.*, 792 F.2d (1140 (D.C. Cir.) *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005); *In re Millennium Lab Holdings II*, 945 F.3d 126 (3d Cir. 2019); *In re A.H. Robins, Inc.*, 760 F.3d 344 (4th Cir.); *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002); *In re Specialty Equip. Co.*, 3 F.3d 1043 (7th Cir. 1993); *In re Seaside Eng'g & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015).

— In the minority view, non-consensual third-party releases are in direct conflict with the statutory prohibition on discharges for non-debtor third parties. Moreover, these courts also refuse to rely on the equitable powers of Section 105 of the Bankruptcy Code to approve non-consensual third-party releases due to the inherent conflict with Section 524(e) of the Bankruptcy Code. *See* G Collier on Bankruptcy (16th 2021)*; see generally In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009); *Resorts Int'l, Inc. v. Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *Landsing Diversified Properties-II v. First Nat'l Bank and Trust Co. of Tulsa*, 922 F.2d 592 (10th Cir. 1990).

Where non-consensual third-party releases are allowed, courts have approved these releases in certain limited circumstances where various iterations of these five factors weighed in favor of the releases:

(1) an identity of interest between the debtor and the third party, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate;

(2) substantial contribution by the non-debtor of assets to the reorganization;

(3) the essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success;

(4) an agreement by a substantial majority of the impacted class or classes to accept the Chapter 11 plan; and

(5) a provision in the Chapter 11 plan for payment of all or substantially all of the class or classes affected by the injunction.

See In re Zenith Electronics Corp., 241 B.R. 92, 110 (Bankr. D. Del. 1999).

Another iteration of these factors is whether:

(1) the estate received substantial consideration;

(2) the enjoined claims were channeled to a settlement fund rather than being extinguished;

(3) the enjoined claims would directly impact the debtor's reorganization by way of indemnity or contribution; and

(4) the plan otherwise provided for the full payment of the enjoined claims; or

(5) the affected creditors consent to the releases.

See In re Metromedia Fiber Network, Inc., 416 F.3d 136, 142 (2d Cir. 2005).

Receiving a non-consensual release requires a significant contribution to the restructuring as consideration. What constitutes a significant contribution can often lead to contentious litigation. *See In re Millennium Lab Holdings II*, 945 F.3d 126, 131-32 (3d Cir. 2019) ("The release provisions . . . [were] 'heavily negotiated among the Debtors, the Equity Holders and the Ad Hoc Group' and necessary to the entire agreed resolution… They 'were specifically demanded by the Equity Holders as a condition to making the[ir] contribution' and, without them, [the primary shareholders] 'would not have agreed' to the settlement."); *In re Purdue Pharma*, No. 19-23649 (S.D.N.Y. Sept. 17, 2021) ("The consideration… including $4.275 billion in cash and 100% of the equity interests in Purdue Pharma L.P.… constitutes a substantial contribution to the Estates.").

Non-consensual third-party releases are often controversial releases that may be heavily scrutinized by parties in interest, the public, governmental entities and even Congress, as evidenced in recent high-profile cases such as Purdue Pharma, Boy Scouts of America and USA Gymnastics. Recent cases in the Southern District of New York, the Eastern District of Virginia and Delaware are in conflict as to the availability of third-party releases.

— On December 16, 2021, the United States District Court for the Southern District of New York vacated the Purdue Pharma confirmation order that included non-consensual third-party releases for shareholders in exchange for a financial contribution to the estate, failing to find any statutory basis for permitting third-party releases of non-derivative claims.

— Similarly, on January 13, 2022, the District Court for the Eastern District of Virginia vacated Ascena Retail Group's confirmation order due to the third-party releases therein finding, among other things, that the *Dow Corning* factors were not met because the released parties did not provide a substantial contribution to the debtors' estates, the lack of releases would not impact implementation of the plan, there was no consent by releasing parties even though releasing parties had the ability to opt out of the releases and the Bankruptcy Court lacked authority to approve the releases.

— On February 3, 2022, the Bankruptcy Court for the District of Delaware confirmed Mallinckrodt PLC's plan, including the third-party releases therein, despite the recent Ascena and Purdue Pharma holdings because the releases comported with prevailing Third Circuit precedent because they were necessary to the reorganization and fair to the parties.

— On February 15, 2022, the United States Bankruptcy Court for the District of Delaware rejected the third-party releases in Kettner Investments' plan, finding that the creditors did not have the opportunity to opt out of the releases, disagreeing with Kettner's counsel that the ability to object to the releases was adequate to allow the creditors to opt out and finding that there was no basis for granting non-consensual releases.

Practical considerations

Prior to an in-court or out-of-court restructuring transaction, directors and officers evaluating transactions under distressed market conditions should remain mindful of the varied interests of all stakeholders and should evaluate whether the transaction is designed to maximize the value of the company. This process includes, among other things, an evaluation of the appropriateness of a company granting releases, especially when releases are being granted to parties that are (1) tasked with authoring the transaction; i.e., members of the board of directors or (2) affiliated with the parties tasked with authorizing the transaction; i.e., a sponsor.

Adequate guardrails including optimal governance should be established to analyze potential claims and causes of action. An investigation and evaluation should be conducted to assess and estimate whether there are existing or potential claims or causes of action, the potential value of any existing or potential claims or causes of action and the likelihood that the company could recover on any existing or potential claims or causes of action. A protective process for the company may be to have an independent director or independent committee perform the evaluation described above prior to any release being granted or provided by the company.

A preemptive investigation may help expedite the bankruptcy process, which in turn could reduce cost, increase certainty and, among other things, encourage participation from parties in interest in any restructuring process. It is important that the company develop an evidentiary record to support any releases granted by the company. Ultimately, who and what the company decides to release is, and should be, a value-maximizing exercise based on an evidentiary record that supports the economic rationale of the company and its business judgment.

Conclusions

Releases in restructuring can be useful tools for obtaining consensus and cooperation, helping to avoid future litigation to vital parts of the bankruptcy process. The process for approving and granting releases should be established, well documented and based upon independent judgment and advice. While the use of releases for company claims is well-accepted, the use of releases for other third-party claims has been and continues to be subject to higher scrutiny and potential controversy. The landscape for third-party releases is evolving, and practitioners will need to adapt to potential new legislation and review. Releases should serve as a value-maximizing tool for the benefit of all stakeholders.

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22 LITIGATION TRUSTS

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Purposes

A litigation trust creates optionality in restructurings by providing a contingent source of recoveries under a Chapter 11 plan for creditors that might be "out of the money" based solely on a company's enterprise value. The litigation trust can take by assignment the debtor in possession's (that is, the estate's) and the direct creditors' causes of action to be prosecuted for the benefit of the holders of litigation trust interests. The proceeds of successfully prosecuted claims are a form of plan consideration beyond cash or equity in the reorganized company that may be consumed by secured or otherwise senior creditors. Litigation trusts also help bring Chapter 11 cases to a conclusion more quickly. Thus, they serve the debtor's primary business goal of reorganizing and leaving the past behind. By employing litigation trusts, companies need not await the final adjudication or settlement of the causes of action (the prosecution of which can take years) to emerge from Chapter 11 protection.[1]

Mechanics

Standing to sue (11 U.S.C. § 1123(b)(3))

Claims may be retained and enforced by the trust pursuant to section 1123(b)(3)(B) of the Bankruptcy Code, which enables a Chapter 11 plan to "provide for (A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or (B) the retention and enforcement by the debtor, by the trustee, ***or by a representative of the***

[1] See *In re Acequia, Inc.*, 34 F.3d 800 (9th Cir. 1994) ("[The] aim [of section 1123(b)(3)(B)] was to make possible the formulation and consummation of a plan before completion of the investigation and prosecution of causes of action. … Thus, the statute as in furtherance of the purpose of preserving all assets of the estate while facilitating confirmation of a plan.").

estate appointed for such purpose, of any such claim or interest …."[2] Trusts can also take, by assignment, individual causes of action (against third parties, not the debtor) that are contributed by creditors directly to the litigation trust whose debt claims are discharged in exchange for litigation trust interests distributed under the plan.[3] The claims of individual creditors may not face the same defenses as claims belonging to the debtor's estate, which are subject to the same defenses when prosecuted by the trustee-assignee that would have been available had the claims been prosecuted by the debtor.[4] However, not all courts exempt individual creditor claims from defenses applicable to estate claims, such as the Bankruptcy Code's safe harbor provisions, or otherwise willingly recognize their assignment to a litigation trust.[5]

Governance

Given the potential importance of litigation to creditor recoveries, creditors are keen to have a say in the management of the litigation trust. These aspects of trust governance include agreements on the selection and appointment of the trustee, the selection and appointment of members of a trust advisory board to supervise the trustee, the litigation trustee's obligation to distribute the proceeds of causes of action (subject to the payment of trust expenses) and the litigation trustee's authority to settle causes of action. Governance terms appear in the plan and litigation trust agreement — a separate, plan-support document typically filed publicly along with other materials necessary for voting on the plan.[6]

[2] See *Torch Liquidating Trust v. Stockstill*, 561 F.3d 377, 387 (5th Cir. 2009) ("Section 1123(b)(3) therefore allows a plan to transfer to a trustee of a liquidating trust the authority to enforce an estate's claims …").

[3] See *In re AOG Enter., Inc.*, 569 B.R. 563, 568 (Bankr. S.D.N.Y. 2017) ("The CORE Litigation Trust… brought this proceeding in the Superior Court for the State of California… as assignee of the Debtors' pre-petition secured lenders, alleging that the Defendants induced a breach of contract between the lenders and certain Debtor entities and intentionally interfered with those contracts"); See *In re Physiotherapy Holdings, Inc.*, No. 13-12965(KG), 2017 WL 5054308, at *2 (Bankr. D. Del. Nov. 1, 2017) ("[T]he Plan also created the Litigation Trust. … [T]he claims of the Debtors, Court Square, and the Noteholders (collectively, the 'Contributing Claimants') were transferred to the Litigation Trust, including any avoidance claims. … The Litigation Trust was designated an estate representative authorized to retain and pursue all such causes of action.").

[4] See *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.,* 267 F.3d 340, 356 (3rd Cir. 2001) ("[I]n actions brought by the trustee as successor to the debtor's interest under section 541, the trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] [t]he trustee is, of course, subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor.").

[5] See *In re Tribune Fraudulent Conveyance Litigation*, 946 F.3d 66 (2nd Cir. 2019) (bankruptcy code's defenses to avoidance actions apply to individual creditors' avoidance claims to the same extent); See *Williams v. California 1st Bank*, 859 F.2d 664, 667 (9th Cir. 1988) (bankruptcy trustee lacked standing to sue on claims assigned to it by investors because trustee "had no claim" of its own, and the trustee's prosecution created risk of inconsistent results to actions brought by non-assigning investors); See *Semi-Tech Litig., LLC v. Bankers Tr. Co.*, 272 F. Supp. 2d 319, 324 (S.D.N.Y. 2003) ("[T]here always is a risk, outside the bankruptcy context, that a non-assigning note or debenture holder may sue and obtain results inconsistent with a result obtained by an assignee of an identical claim, but that affords no basis for refusing to allow suit on assigned claims. The Court sees no basis for treating an assignee created by, or assignments made pursuant to, a Chapter 11 plan any differently.").

[6] See *In re Residential Capital LLC, et al.*, Case No. 12-12020 (MG) (Bankr. S.D.N.Y.) [ECF No. 6136] (Liquidating Trust Agreement) p. 31 (§ 6.2) ("[T]he Liquidating Trust Board shall consist of five (5) Liquidating Trustees … set forth on the signature page to this Liquidating Trust Agreement"); p.34 (§ 6.4) ("[T]he Liquidating Trust Board shall be expressly authorized … to investigate, prosecute, settle, liquidate, dispose of, and/or abandon the Liquidating Trust Assets, including rights, Avoidance Actions, other Liquidating Trust Causes of Action or litigation previously held by the Debtors or their Estates"); p. 27 (§ 5.1) ("[T]he Liquidating Trust (i) shall distribute to each Unitholder of record on the next preceding Distribution Record Date … an amount equal to its respective Pro Rata share of the Distributable Cash."); *In re Remington Outdoor Co., Inc., et al.*, Case No. 18-10684 (BLS) (Bankr. D. Del.) [ECF No. 186-3] (Litigation Trust Agreement) p. 2 (§ 1.1)

The Chapter 11 plan and litigation trust agreement may also contain provisions prioritizing the distribution of litigation proceeds. A plan can create different classes of litigation trust interests, (e.g., affording senior creditors "Class A" interests with first priority to proceeds and junior creditors "Class B" interests with second priority to proceeds). What is more, certain creditors may have claims against debtor entities that own causes of action separately from their debtor affiliates. For example, a parent company may have its own creditors and own an estate cause of action that its subsidiaries (and their respective creditors) do not. Yet, the subsidiaries' creditors might be more incentivized to fund a litigation trust (and demand a first-priority to proceeds) because of their structural seniority over parent-company creditors. The litigation trust agreement can be drafted to address these types of intercreditor issues.[7]

Funding

Increasingly, a litigation trust will be endowed with a sufficient "war chest" to prevent defendants from deterring viable claims on account of expensive delay tactics designed to drain the trust's finite resources. If sufficient "seed money" is not provided by the debtor under the reorganization plan, litigation trustees can pursue funding options that include third-party litigation financing for the hourly payment of retained professionals, the retention of professionals on a contingent-fee basis or some hybrid arrangement. In addition, the full extent of litigation costs often is unknown at the time the plan is confirmed. It therefore is not uncommon for the litigation trust agreement to authorize the trustee to secure litigation financing from a third party to fund expenses in exchange for a priority recovery from litigation proceeds.[8] Negotiating these provisions requires a balancing of the need to ensure the trust can faithfully prosecute the causes of action against the risk that recoveries will be diluted by first-priority returns to the litigation funder.

Transferability of trust interests

The ability to transfer litigation trust interests as if they were tradeable securities increases their value as a form of plan consideration.[9] It enables the litigation trust beneficiaries to exit the credit if they have no appetite for the risk and delay associated with litigation. The transferability of trust interests,

("Establishment of Litigation Trust and Appointment of the Litigation Trustee and the Litigation Trust Advisory Board"); p. 9 (§ 3.1) ("[T]he Litigation Trustee shall … at the Direction of the Litigation Trust Advisory Board, … prosecute … and … settle … the Litigation Claims"); p. 9 (§ 3.3) ("The Litigation Trust Advisory Board shall have the absolute right to provide Direction to the Litigation Trustee to prosecute … settle, or take any other action …"); p. 10 (§ 3.5) ("[T]he first $5,000,000 of any aggregate net proceeds of the Litigation Claims shall be allocated [by the Litigation Trustee] on a pro rata basis to the holders of Litigation Trust Class B Interests … and any recoveries in excess of $5,000,000 … shall be shared equally among the holders of Litigation Trust Class A Interests and holders of the Litigation Trust Class B Interests"); *In re Sanchez Energy Corp.*, Case. No 19-34508 (Bankr. S.D. Tex.) [ECF No. 1289] (Order authorizing trustee to pay expenses out of litigation proceeds).

[7] See, *In re Remington Outdoor Co., Inc., et al.*, Case No. 18-10684 (BLS) (Bankr. D. Del.) [ECF No. 186-3] (Litigation Trust Agreement) p. 10 (§ 3.5) ("Where recoveries relate to more than one Litigation Claim, the Litigation Trustee shall classify and allocate recoveries from Litigation Claims. … The holders of Litigation Trust Class B Interests shall receive all recovery amounts from any Litigation Claims that (i) are exclusively related to amounts transferred within applicable statutes of limitations from [parent] ROC to any transferee, or (ii) belong solely to ROC").

[8] See *In re Downey Fin. Corp.*, 499 B.R. 439, 450 (Bankr. D. Del. 2013), *aff'd,* 593 F. App'x 123 (3d Cir. 2015) (recovery of $373,791,733 realized by the litigation trust subject to litigation financing provided by estate creditors); *In re The Colonial BancGroup, Inc.*, Case No. 09-32303-DHW (Bankr. M.D. Ala. 2010) (similar structure in place); *In re Sanchez Energy Corp.*, Case. No 19-34508 (Bankr. S.D. Tex.) [ECF No. 1289] (Order authorizing trustee to pay expenses out of litigation proceeds); *In re SNTL Corp., et al.*, No. 00-14099-GM (Bankr. C.D. Cal. Dec. 20, 2013) (Order Approving Trust Financing).

[9] See *In re Residential Capital LLC, et al.*, Case No. 12-12020 (MG) (Bankr. S.D.N.Y.) [ECF No. 6136-1] (Liquidating Trust Agreement) p. 26 (§ 4.6) ("Units shall be freely negotiable and transferable to the extent provided herein and the provisions of applicable securities laws.").

however, implicates tax and securities laws, which adds complications that may not be appropriate for every trust. The terms of the trust must be consulted to determine their transferability.

Preserving debtors' privileges

Section 1123(b)(3) allows a Chapter 11 debtor to assign its privileges to the litigation trust. Importantly, the litigation trustee can inherit all the protections attendant to any such privileges, including attorney-client and work-product protections relating to the assigned claims the plan appointed the trustee to prosecute. Both the Chapter 11 plan and the confirmation order should specifically include these privileges within the definition of assets transferred to the trust.[10]

Nature of claims

Courts consider a company that has become a Chapter 11 debtor in possession to have assumed a different juridical status post-petition than it held pre-petition.[11] This distinction has several implications, such as the power to assume or reject pre-petition contracts under section 365 of the Bankruptcy Code to which the debtor is a party. Critically, one distinction is the ability of the debtor in possession and the litigation trustee to challenge pre-petition transactions to which the debtor was a party.

Chapter 5 actions

The debtor in possession and, after confirmation, the litigation trustee enjoy what has become known colloquially as "strong arm powers" under chapter 5 of the Bankruptcy Code that can be used to avoid (or undo) certain pre-petition transfers the debtor made to third parties or obligations it incurred pre-petition. Under section 547(b) of the Bankruptcy Code, such a transfer is avoidable as a "preference" if it was (1) made while the debtor was insolvent; (2) made within 90 days of the petition date (or, if the payment was made to an "insider" within 1 year of the petition date); (3) made on account of antecedent debt; and (4) results in the transferee receiving a greater distribution than it would receive in a hypothetical liquidation of the debtor.[12] Section 548 of the Bankruptcy Code provides for the avoidance of transfers of an interest of the debtor in property or any obligation incurred by the debtor within two years of the petition date. Under section 548(a)(1)(A), the litigation trustee may avoid a transfer or an obligation if the transfer was made or if the obligation was incurred with the intent to hinder, delay or defraud creditors. Such claims are known as "actual intent" claims, and they may be proven by establishing certain "badges of fraud."[13] Under

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[10] See *In re Remington Outdoor Co., Inc., et al.*, Case No. 18-10684 (BLS) (Bankr. D. Del.) [ECF No. 248-1] (First Amended Joint Prepackaged Chapter 11 Plan of Remington Outdoor Company, Inc. And Its Affiliated Debtors And Debtors In Possession (Technical Modifications)) at p. 3 (¶ 24) (defining "Causes of Action" to include "any … cause of action … power, privilege … of any kind or character whatsoever"); at p. 41 ("In connection with the vesting and transfer of the Litigation Trust Assets, any attorney-client privilege, work-product privilege, or other privilege or immunity attaching to any documents or communications … relating to the Litigation Trust Assets … shall vest in the Litigation Trust"); [ECF No. 248] (Order (A) Approving Solicitation Procedures, (B) Approving Adequacy of Disclosure Statement, And (C) Confirming Plan) at p. 17 (¶ 12) (same).

[11] *C.f., In re Advanced Contacting Solutions, LLC*, 582 B.R. 285, 304 (Bankr. S.D.N.Y. 2018) ("[T]he law distinguishes between the debtor before and after the filing"); *In re Genuity, Inc.*, 323 B.R. 79, 83 (Bankr. S.D.N.Y. 2005) (noting there is no crossover of claims in setoff because "the debtor and the debtor-in-possession are two separate and distinct entities which act in different capacities pre- and post-petition").

[12] See 11 U.S.C. § 547(b) (Certain pre-petition preferences are exempted from avoidance under section 547(c), such as where the transfer was made in exchange for a new value or made in the ordinary course. These exemptions apply to the litigation trustee just as they would to the debtor in possession).

[13] See *In re Tribune Fraudulent Conveyance Litigation*, No. 19-3049-cv (2d Cir. Aug. 20, 2021) ("Courts have inferred intent to defraud from the concealment of facts and false pretenses by the transferor, reservation by [the transferor] of rights in the transferred property, the transferor's absconding with or secreting the proceeds of the transfer immediately after their receipt, the existence of an unconscionable discrepancy between the value of property transferred and the consideration received

section 548(a)(1)(B), the litigation trustee may avoid a transfer or an obligation that was made or incurred for a less than reasonably equivalent value and that rendered the debtor insolvent or unable to pay its debts as they became due or left the debtor with unreasonably small capital. Such claims are known as "constructive fraudulent transfer claims." Unlike actual intent claims, the transferor's intent is not relevant to constructive fraudulent transfer claims. Also, certain transferees may be protected from constructive fraudulent transfer claims by the Bankruptcy Code's "safe harbor" provisions, which generally insulate certain payments made under securities contracts and to or for the benefit of financial participants from challenge.[14]

Section 544 of the Bankruptcy Code enables the litigation trustee to bring avoidance claims under applicable state law. Fraudulent conveyance and transfer statutes in most states are substantively similar to section 548 of the Bankruptcy Code.[15] And, some courts have found that safe harbor provisions do not bar constructive fraudulent transfer claims from being brought under state law.[16] State law claims contain longer look-back periods than the two-year look-back period under the Bankruptcy Code, enabling the litigation trustee to challenge transactions that took place as long as four to six years — or in some cases, even longer — before the petition date. While states do not typically have analogous preference provisions, the Uniform Voidable Transaction Act (and its immediate predecessor) recognize challenges to "insider" preferences.[17]

Common law claims

While state law claims, such as claims for breach of fiduciary duty or unjust enrichment, are not "bankruptcy" claims per se, any and all of the debtor's pre-petition causes of action are automatically made part of the "property of the estate" under section 541 of the Bankruptcy Code and susceptible to assignment to the litigation trust. Depending on the circumstances, typical targets of such claims include the debtors' officers and directors as well as private equity sponsors or entities that might have exercised outsized influence over the debtors (e.g., counterparties to mission critical contracts). Claims against third party advisors or auditors for malpractice or aiding and abetting breach of fiduciary duty also become property of the estate, subject to state law defenses applicable against the debtor.

Claim objections

Most plans provide that, as a "party in interest," the litigation trustee has standing to object to claims filed against the estate.[18] Objections may challenge claim amounts or classification of filed claims, among other issues. The plan and related confirmation order typically set a deadline for any such objections to be filed. These objections can

therefor, the oppressed debtor's creation of a closely-held corporation to receive the transfer of his property, as well as the oppressed debtor's transfer of property while insolvent.").

[14] Section 546 of the Bankruptcy Code contains certain safe harbors for transfers or obligations that would otherwise be considered avoidable as constructive fraudulent transfers. These safe harbors apply to claims brought by the litigation trustee just as they would if they were brought by the debtor in possession.

[15] Section 544 of the Bankruptcy Code allows the debtor in possession or litigation trustee to stand in the shoes of an existing unsecured creditor to bring state fraudulent conveyance claims.

[16] See *In re Physiotherapy Holdings, Inc.*, (D. Del. Dec. 21, 2017) ("Nor is the Court convinced that a substantial ground for difference of opinion exists, as the Bankruptcy Court's preemption analysis followed well-established Third Circuit and Supreme Court law") (citing *PAH Litig. Trust v. Water St. Healthcare Partners L.P., et al. (In re Physiotherapy Holdings, Inc.)*, 2016 WL 3611831 (Bankr. D. Del. June 20, 2016) and *In re Lyondell Chemical Co.*, 503 B.R. 348, 373 (S.D.N.Y. 2014)).

[17] See *In re Musicland Holding Corp.*, 462 B.R. 66, 72 (Bankr. S.D.N.Y. 2011) ("UFTA § 5(b), condemns insider preferences by an insolvent debtor.").

[18] See 11 U.S.C. § 502(a) ("A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.").

be logged independently as a "contested matter" or joined with affirmative claims in an adversary proceeding brought by the litigation trustee.[19]

Considerations when bringing suit

There are several considerations that have special significance to the ultimate decision to bring suit. These include satisfying any applicable statutes of limitation, identifying potential claims through Rule 2004 discovery and choosing a venue.

Timing & tolling (11 U.S.C. §§ 108(a) and 546(a))

The Bankruptcy Code gives the debtor in possession the benefit of additional tolling for statutes of limitation that have not expired as of the petition date. Specifically, section 108(a) provides that "[i]f applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of … the end of such period … or two years after the order for relief." Section 108(a) preserves claims for which a statute of limitations has not expired for two years during a bankruptcy case. The two-year limitation period prescribed in section 546(a) of the Bankruptcy Code operates independently, requiring that claims under sections 544 (state law avoidance claims), 547 (preferences) and 548 (fraudulent transfers) of the Bankruptcy Code must be brought within two years of the petition date.[20] And debtors should be careful in understanding the impact of closing the Chapter 11 cases under section 350 of the Bankruptcy Code on that deadline.[21]

Post-confirmation rule 2004 examinations

Bankruptcy Rule 2004 states that "[o]n motion of any party in interest, the court may order the examination of any entity."[22] The examination can concern the acts, conduct or property of the debtor; the liabilities and financial condition of the debtor; or any matter which may affect the administration of the debtor's estate. Rule 2004 discovery can be propounded by the debtor in possession on third parties, by third parties on the debtor or even by third parties on other third parties in certain circumstances. Rule 2004 is a valuable tool because it helps unearth potential causes of action that may be unknown to the litigation trustee. Yet, the litigation trustee's ability to invoke Rule 2004 after a Chapter 11 plan is confirmed is not certain. Courts have declined relief post-confirmation, finding in some circumstances that it may give the litigation trustee an unfair advantage.[23]

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[19] See Fed. R. Bankr. P. 3007 (b) ("A party in interest shall not include a demand for relief of the kind specified in Rule 7001 in an objection to the allowance of a claim, but may include such a claim in an adversary proceeding").

[20] *In re Maxway Corp.*, 27 F.3d 980, 983-84 (4th Cir. 1994) ("[B]y its terms, § 546(a) applies both to trustees and debtors in possession, requiring both to commence an action within the specified time periods.").

[21] See *5 Collier On Bankruptcy* ¶ 546.02[2][b] (Richard Levin & Henry J. Sommer eds., 16th ed.) ("[I]f a case is closed and then reopened under Section 350(b) of the Bankruptcy Code, it is not clear … whether the closure of the case will operate to bar avoidance actions" that are otherwise timely; noting "[i]n light of this ambiguity, courts have interpreted the word 'closed' in section 546(a)(2) to mean 'properly and finally' closed, [where a] case is not properly or finally closed unless all assets, including avoidance actions, are administered."); *In re Kopp*, 383 B.R. 179, 186 (Bankr. D. Kan. 2008) ("[T]he trustees in these case were allowed to proceed with avoidance actions even when the actions were not commenced until after the cases had been closed then reopened."); *In re Mullen*, 337 B.R. 744, 749 (Bankr. D. N.H. 2006) ("section 546(a) bars the resurrection of … an [avoidance] action or proceeding in the event that the case is reopened.").

[22] Fed. R Bankr. P. 2004.

[23] See *In re Millennium Lab Holdings II, LLC*, 562 B.R. 614, 627-29 (Bankr. D. Del. 2016) (plan created two litigation trusts, one with estate claims (the "Corporate Trust") and one with individual creditor claims (the "Lender Trust"); Rule 2004 motion granted with respect to the first trust's claims and

Venue

The choice of forum presents a critical question. The Bankruptcy Court may provide a more strategic and practical forum given its familiarity with the Chapter 11 cases. However, a state court may be a better alternative depending on the claims asserted and the need for a jury trial.[24] Courts usually defer to a plaintiff's choice of forum, and that deference should apply to the litigation trustee.[25]

Filing in state court

While claims under the Bankruptcy Code, like preference claims under section 547, may not be available in state court, there are state law analogs for fraudulent transfer claims and in limited states, "insider" preference claims. Also, a defendant may try to move a state court action to federal court, specifically the United States District Court in the jurisdiction where the litigation trustee brought the action. (If the state court action is brought in the same state where the bankruptcy is pending, the case will likely be referred automatically by the United States District Court to the Bankruptcy Court). After removal, however, the Bankruptcy Court may decide to abstain from hearing the trust's claims. Under 28 U.S.C. § 1334(c)(2), a Bankruptcy Court must abstain from hearing certain types of cases that are "related to" a bankruptcy case, but not "arising under" the Bankruptcy Code or "arising in a case" under the Bankruptcy Code, if there is a case pending in state court that can be timely adjudicated. Non-core proceedings concerning the allowance or disallowance of claims, however, cannot be dismissed by a Bankruptcy Court on mandatory abstention grounds.[26] Furthermore, under 28 U.S.C. § 1334(c)(1), a Bankruptcy Court can permissively abstain even from disputes involving the Bankruptcy Court's "core" jurisdiction. Upon abstention, pursuant to 28 U.S.C. § 1452(b), the court may remand an action that was previously removed from state court back to state court "on any equitable ground."

Filing in bankruptcy court

There may be jurisdictional impediments to the litigation trust pursuing claims in the Bankruptcy Court, particularly after confirmation, subjecting the lawsuit to dismissal for lack of subject matter (or federal question) jurisdiction. Congress authorized Bankruptcy Courts to enter orders and judgments in "core proceedings," which includes all bankruptcy cases, all civil proceedings arising under the Bankruptcy Code (e.g., claims under chapter 5 of the Bankruptcy Code) and all civil proceedings

denied with respect to the second trust's claims because "Rule 2004 was not intended to provide private litigants [i.e., the Consenting Lenders] with a strategic advantage in fishing for potential private litigation;" noting "the granting of the Trustee's request for Rule 2004 examinations with respect to the Corporate Trust effectively provides the Trustee with the information sought in both of his capacities."). See also *In re Daisytek, Inc.*, 323 B.R. 180 (N.D. Tex. 2005) (vacating Bankruptcy Court order allowing a post-confirmation creditors' trust to take a Rule 2004 examination).

[24] Parties can consent to a trial by jury before the Bankruptcy Court. Without that consent, however, a jury trial demand may result in the matter being withdrawn to the United States District Court. See 28 U.S.C. § 157(e) ("If the right to a jury trial applies in a proceeding that may be heard under this section by a bankruptcy judge, the bankruptcy judge may conduct the jury trial if specially designated to exercise such jurisdiction by the district court and with the express consent of all parties").

[25] See *In re Lyondell Chem. Co.*, 543 B.R. 428, 457-58 (Bankr. S.D.N.Y. 2016) (claims brought by trustee under Chapter 11 plan had bona fide connection to bankruptcy court); *In re Bernard Madoff Inv. Sec., LLC*, 525 B.R. 871, 890 (Bankr. S.D.N.Y. 2015) (noting Trustee's choice of forum was entitled to "substantial deference"; "[h]e sued in his 'home court' where the BLMIS SIPA proceeding is pending [and] where he was appointed …"). See *In re Nat'l Bank of Anguilla (Private Banking Tr.) Ltd.*, 580 B.R. 64, 75–76, 85–86 (Bankr. S.D.N.Y. 2018) (finding forum shopping and declining to defer to foreign representatives' choice of forum when debtors commenced cases for purpose of facilitating avoidance actions); *Seidel v. Ritter (In re Kinbrace Corp.)*, 2017 WL 1380524, at *5 (Bankr. S.D.N.Y. Apr. 17, 2017) (even with "lesser deference" afforded to chapter 7 trustee prosecuting Liberian corporation's claims, the court still "assume[d] that [trustee's forum choice] weighs in favor of retaining litigation in this Court").

[26] See 28 U.S.C. § 157(b)(4).

"arising in" bankruptcy cases (e.g., DIP financing and confirmation disputes). "Core" proceedings do not include other civil proceedings that are merely "related to" bankruptcy cases — meaning they do not arise in bankruptcy or "but for" the bankruptcy, but their outcome may have a conceivable impact on the bankruptcy estates, such as by increasing creditor distributions.[27] Moreover, while no federal statute limits the Bankruptcy Court's jurisdiction post-confirmation, courts have concluded otherwise.[28]

It is possible that a defendant will request the United States District Court to "withdraw the reference" that was given to the Bankruptcy Court. A United States District Court controls the bankruptcy system within its district and, under 28 U.S.C. § 157(d), may withdraw in whole or in part matters that have been referred to the Bankruptcy Court by it, for good cause shown, either on motion of a party or sua sponte.[29] The power to withdraw extends to both core and non-core matters. While typically discretionary, under certain circumstances, the United States District Court must withdraw the reference (e.g., when the matter's resolution requires the Bankruptcy Court to engage in significant interpretation, not just simple application, of federal non-bankruptcy law, such as regulatory law against a debtor under a federal environmental protection statute).

Finally, steps can be taken to best preserve the Bankruptcy Court's jurisdiction after it confirms the Chapter 11 plan. The plan proponent must ensure that the Chapter 11 plan and confirmation order specifically provide for the retention of Bankruptcy Court jurisdiction over all of the claims that the litigation trustee might wish to pursue in Bankruptcy Court.[30] Similarly, complaints that bring bankruptcy claims along with state law claims and join any claim objections under section 502 to the adversary complaint pursuant to Bankruptcy Rule 3007(b) arguably have more of a connection to the Bankruptcy Court than those suits resting entirely on state law.

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[27] In certain cases, even where the claim is defined by 28 U.S.C. § 157 as "core," a court may not consider it Constitutionally "core" if it does not relate to the bankruptcy claims reconciliation process. In that instance, the Bankruptcy Court may not be able to enter a "final" order, and its factual findings may be subject to de novo review by the District Court. See *Exec. Benefits Ins. Agency v. Arkison*, 573 U.S. 25, 35, 134 S. Ct. 2165, 2172, 189 L. Ed. 2d 83 (2014) ("[S]ome claims labeled by Congress as 'core' may not be adjudicated by a bankruptcy court in the manner designated by § 157(b)."); *Stern v. Marshall*, 564 U.S. 462 (2011) (bankruptcy judge could not enter final judgment on state law counterclaims that were not resolved in the process of ruling on a creditor's proof of claim; the counterclaim was considered non-core despite falling under statutory definition of "core").

[28] See *N. Am. Car Corp. v. Peerless Weighing & Vending Mach. Corp.*, 143 F.2d 938, 940 (2nd Cir. 1944) ("Since the purpose of reorganization clearly is to rehabilitate the business and start it off on a new and to-be-hoped-for more successful career, it should be the objective of courts to cast off as quickly as possible all leading strings which may limit and hamper its activities and throw doubt upon its responsibility."); *In re Gen. Media, Inc.*, 335 B.R. 66, 73–74 (Bankr. S.D.N.Y. 2005) (the party invoking post-confirmation jurisdiction must show that a matter has a "close nexus to the bankruptcy plan or proceeding, as when a matter affects the interpretation, implementation, consummation, execution, or administration of the confirmed plan or incorporated litigation trust agreement … [And,] the plan must provide for the retention of jurisdiction over the dispute.").

[29] A Chapter 11 case technically is filed in the United States District Court. Most district courts, however, have orders automatically referring all bankruptcy matters to the Bankruptcy Court. See United States Southern District of New York Amended Standing Order of Reference M-431. Note that while motions to withdraw the reference are technically filed with the pertinent District Court, certain jurisdictions have ordered that such motions be referred to the Bankruptcy Court for the issuance of report and recommendation to the District Court. See *In re Memorial Production Partners, LP*, Civil Action No. H-18-411 (S.D. Tex. Sept. 20, 2018) (adopting in full the Bankruptcy Court's report and recommendation that the reference not be withdrawn).

[30] Of course, a "court cannot write its own jurisdictional ticket." See *Zerand-Bernal Group, Inc. v. Cox*, 23 F.3d 159 (7th Cir. 1994).

23 NEXT STOP: THE INSOLVENCY ZONE

INDUSTRY ORGANIZATION PERSPECTIVE

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Picture the scene: the director of a corporation, already pressured by declining sales and supply-chain issues, receives a visit from the CFO. Her news isn't good. The numbers show that sales are down for the third straight quarter. How the director responds at this moment will be critical for the business's future.

But even when presented with proof of declining sales, a business owner, for reasons that can be entirely human or simply muddled by the daily uncertainties of the business world, may delay making the kind of decisions needed to stave off financial disaster. "Perhaps it's just a short-term blip," the owner may think, or "we need to beef up our sales team" — anything to put off the more painful choices of laying off workers or taking some other severe action to cut costs.

Often, the true reality check of a company's financial fortunes will be triggered by some outside event: the cost of borrowing suddenly shoots up — or financing simply becomes unavailable — or the company fails to land a significant new contract. By the time such an event forces the company to recognize its poor financial outlook, the situation may have dipped into an even more precarious situation — one that puts the CEO and the company's board members not just into financial jeopardy but, quite possibly, in legal peril as well.

In approximately half of all Chapter 11 cases, the directors and officers of the debtor company are sued for breach of fiduciary responsibility. Why is this? It is due to something called the "zone of insolvency," a concept reinforced by several key court decisions, particularly in the state of Delaware, where many publicly held companies have a foothold. When a company enters this zone, decisions made by the directors can violate certain obligations that they have to the shareholders of the company.

Here is where things get tricky, though: the courts don't always agree on *when* a company has entered the mysterious zone of insolvency. That means that directors — like the one in our example — may already be in dangerous territory without realizing it, and their natural tendency to hope for the best, and to weather trying times with optimism that things will ultimately turn around, may only compound the peril of their position.

Loyalty and care

With almost 70 percent of Fortune 500 companies incorporated in Delaware, and close to 90 percent of all corporations based in the United States making their initial public offerings in the state, it should come as no surprise that much of the case law and recognized corporate best practices are built on concepts derived from Delaware corporate law. Indeed, the Model Business Corporation Act ("MBCA") — which was established in Delaware in the late 1990s and has been continually revised since that time by the Business Law Section of the American Bar Association — lays out many of the principles governing best practices for corporate officers. (See *Model Bus. Corp. Act Annual, 2020, Am. Bar. Ass'n*, 5th ed., revised 2016.)

These guidelines boil down to two main principles that govern how company directors should operate: *loyalty* and *care*. The duty of loyalty forbids directors from using their position of trust and confidence to further their private interests or the interests of others not shared by the corporation's stockholders at large. In essence, it requires that directors act in the best interest of the corporation and that shareholder interests take precedence over any interest possessed by a director. Accordingly, a director may not misappropriate assets entrusted to his or her management and oversight, nor may he or she engage in self-interested transactions with the corporation unless the terms of those transactions are entirely fair. The duty of care requires that directors consider all material information reasonably available in making business decisions and use the level of care that an ordinarily careful and prudent director would use in similar circumstances. Put simply, this means that in order to minimize exposure to personal liability, directors should be aware of the substance of the corporate governance documents, regularly assess the corporation's financial position and seek guidance from other directors and professionals as appropriate.

The slippery slope of deepening insolvency

As noted before, the trickiest terrain for the director comes when a company is entering distressed territory because there is no "one size fits all" solution. One shareholder might look at a company in financial straits and conclude that bankruptcy is the best option; another might examine the same financial records and determine that a sale is the best option.

But the person tasked with making that call — the director — is caught in a similar quandary, trying to navigate the best course back to profitability, but he or she is hamstrung by his or her fiduciary obligations to the shareholders, all the while still trying to manage the company to achieve the best outcome for all parties.

It is likely obvious that directors will — and probably should — be held liable if they respond to their distressed circumstances in some grossly negligent fashion. Indeed, the Delaware Supreme Court (*In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 [Del. Ch. 2003].) has articulated three categories of fiduciary misconduct that are "candidates for the 'bad faith' pejorative label." They are:

- conduct undertaken with an actual intent to harm the corporation;
- action undertaken with a lack of due care rising to gross negligence but without malevolent intent; and
- intentional dereliction of duty reflecting a conscious disregard for one's responsibilities.

Most litigation against directors, though, hinges on less obvious grounds, although the legal outlook for directors is not universally gloomy. Many courts will give considerable latitude toward the business expertise of the directors, especially if they made their decisions in consultation with an array of experts in the field and sought counsel from a variety of parties. A court, for instance, will usually not second-guess a decision if it has any rational business purpose, even if the decision ends up being flawed in hindsight and has a significant adverse effect on the corporation.

Certain actions that the director takes, however, will invite more intense scrutiny, especially when the actions involve a sale of company assets. In such circumstances, directors must be especially aware to avoid actual or perceived conflicts of interest.

Tips for mitigating director liability

While a director's duties and obligations depend on the specific facts and applicable law, directors of potentially insolvent companies should consider the following measures to minimize exposure to equity holders and, in certain situations, creditors.

— **Maintain constant and reliable information about the corporation's financial performance:** Having a clear-eyed view of the corporation's financial outlook would likely require frequent consultation with the CFO and outside accountants and consultants. If the true nature of the corporation's financial position is uncertain, it is probably wisest to conclude that the corporation is already in the zone of insolvency.

— **Bring in the right counsel to help make informed decisions:** Directors should seek independent parties that can examine their situation without bias and lend advice. This includes both financial advisors and experienced legal counsel, especially with decisions that involve financial transactions, which may open the door to conflicts of interest.

— **Document the board's decision-making process**: All decisions made by the director and the board should be documented in writing, including any questions, objections or other inquiries that contributed to the process. Board meetings and other communications should all be recorded.

— **Consider purchasing directors and officers insurance and initiating indemnification agreements:** While expensive, directors may mitigate potential liability by purchasing directors and officers ("D&O") insurance and seeking indemnity from the company, as long as the insurance and indemnity agreements are in place before the occurrence of the board decision triggering a shareholder or creditor claim. Care should be taken in the review of the insurance policy, in advance, to provide comfort that the policy provides coverage for breach of fiduciary duty claims of this nature.

— **Understand your Worker Adjustment and Retraining Notification Act liability:** The Worker Adjustment and Retraining Notification ("WARN") Act protects employees by requiring most employers with 100 or more employees to provide 60 calendar days of advance notification of plant closings and mass layoffs. Employees entitled to notice under the WARN Act include managers and supervisors, along with hourly wage and salaried workers. The WARN Act requires that notice also be given to employees' representatives (i.e., a labor union), the local chief elected official (i.e., the mayor) and the state. The purpose of the advance notice is to give workers transition time to seek and obtain other employment, avoid homelessness and so forth. If adequate notice is not given, then the company can be held responsible for paying equivalent wages for the notice period, and if the company cannot pay, then the directors and officers of the company can be held personally liable.

— **Be careful of promises made to vendors:** Businesses in distress will often lean on their vendors to fund working capital. Taking liberties with the credit terms and stretching payments out is all fair game, but as the company's financial situation erodes, the vendors will eventually call and ask, "Why hasn't this invoice been paid?", "When will this invoice be paid?" "Why should we continue to ship to you?". Be careful what your people are telling your trade creditors, because making false statements to obtain further credit (even for one last shipment) can result in personal liability and, in some cases, criminal charges against the officers (or employees) involved.

— **Handle cash reserves wisely:** Directors should avoid funding operating losses by taking on new debt — throwing good money after bad — but should also not make the mistake of waiting until operating funds are dry before shutting the doors. Companies should plan ahead for all of the wind-down costs, such as paying employees accrued wages (including accrued paid time off, as well as commissions and bonuses), employee expense reports, payroll taxes and the administrative costs of the controller or third-party professional that will pay the final bills and hand over the keys to the landlord. Depending on the state(s) in which your business has operations, officers and directors can be personally liable for unpaid wages, taxes and other expenses if not handled properly.

— **Bankruptcy is not the end of the world, but it does not solve all problems either:** Declaring bankruptcy is sometimes the only option for a company to shed its debt and move forward. But it is usually a painful and expensive process, and restructuring will not work in all cases, which is why retaining professional counsel — and possibly hiring a professional restructuring or turnaround specialist — is a vital consideration.

— **If you decide to file for bankruptcy, beware of preference payments:** Part of the Bankruptcy Code specifies that payments to creditors made in the 90 days prior to filing fall into a special category. If the amounts paid exceed what a creditor would receive in the normal course of the bankruptcy proceeding, they constitute what would be called a "preference" and may be denied by the bankruptcy court. Similar scrutiny will be applied to severance payments made to executives or employee bonuses paid out in the period leading up to the filing.

Who needs this headache?

By now, you may be wondering why, given all these potential legal landmines, anyone would agree to become a director or officer of a corporation! The key takeaway: when any individual is asked to serve as an officer or director of a corporation or other alternative business entity, it is incredibly important that they be aware of what duties they will owe the company. In addition, when taking on a such a role, no one typically contemplates that the company may one day be insolvent.

Knowing their fiduciary duties, the standards of review related to those fiduciary duties and potential remedies for violating such duties is imperative when serving in such a capacity. Taking such an engagement on with eyes wide open will only help an officer or director fulfill such duties in compliance with applicable laws.

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Rachel is a Partner at DLA Piper LLP (U.S.). Rachel focuses her practice in the area of corporate restructuring and has extensive experience in healthcare restructurings. Rachel represents debtors, secured creditors, committees of unsecured creditors, purchasers and other interested parties in corporate restructurings, bankruptcy litigation and other bankruptcy-related matters.

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David is an Associate at DLA Piper LLP (U.S.). He represents clients in a variety of industries in bankruptcy courts throughout the United States. David's clients are corporate debtors, trustees, secured and unsecured creditors, purchasers and other stakeholders in a wide range of restructuring matters, including cases under Chapter 11 of the Bankruptcy Code, adversary proceedings, out-of-court workouts, negotiations and sales. He also advises on real estate, intellectual property and other transactional matters where one or more parties is or may become financially distressed.

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Michael Eisenband is the Global Co-Leader of FTI Consulting's Corporate Finance & Restructuring segment and also the leader of Restructuring Services. He is nationally renowned as an industry leader in providing restructuring advice to creditors and companies in complex Chapter 11 and out-of-court workout situations. Mr. Eisenband is a member of the firm's Executive Committee. He has more than 30 years of experience, including industry expertise in retail and consumer products, steel, automotive, airlines, financial services and real estate.

Driven by results, Mr. Eisenband specializes in advising diverse constituencies to maximize recoveries and outcomes and brokering agreements among parties with often disparate interests. He has brought his extensive leadership experience to bear across a range of industries. Arcapita, Caesars Entertainment, Colt Manufacturing, Edison Mission, Energy Future Holdings, General Motors, Lehman Brothers, NII Holdings and Washington Mutual are among Michael's recent and notable engagements.

A representative list of companies that are part of his broad Chapter 11 and out-of-court restructuring case experience also includes Aloha Airlines, Calpine, Cooper Standard, Dana Automotive, Drake Bakeries, Edison Brothers Stores, FoxMeyer, Grand Union, Interstate Bakeries, KB Toys, Long John Silver's, McCrory, Montgomery Ward, Northwest Airlines, Regus Business Centers, Penn Traffic, Phar-Mor, Rite Aid, Service Merchandise, Smurfit-Stone, U.S. Airways and Winn-Dixie.

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Omar Aguilar focuses on broad and rapid enterprise transformation efforts and on providing innovative and lasting solutions to clients at the CEO and board levels in the United States and abroad.
Mr. Aguilar's areas of expertise include strategic cost transformation, margin improvement, restructuring, turnarounds, disruptive cost strategies, broad enterprise transformations and business model transformations enabled by "save-to-turnaround," "save-to-grow" and "save-to-transform" strategies to achieve sustainable results.

Within FTI Consulting, he co-leads the Enterprise Transformation Practice, and leads the Energy & Industrials Business Transformation Practice.

An externally recognized cost management and enterprise transformation expert, Mr. Aguilar has been published widely on the topic of sustainable and scalable cost management and has been quoted by and has written for *Business Strategic Finance, The Journal of Cost Management and The Wall Street Journal*, among others. He is a frequent outside speaker and has been a guest lecturer at the University of Pennsylvania's Wharton School of Business, Stanford University's Graduate School of Business and Carnegie Mellon's Tepper School of Business.

Prior to FTI Consulting, Mr. Aguilar was a Senior Partner at Deloitte Consulting LLP for 17 years where he was the global leader of the Strategic Cost Transformation Practice from 2015 to 2020, with services offered in over 32 countries.

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Craig Cheng specializes in providing financial advisory services in engagements involving troubled situations, strategic evaluation and implementation, mergers and acquisitions and other corporate finance transactions. Mr. Cheng has over 20 years of experience in corporate restructurings, encompassing a number of industries, including automotive, aviation, chemicals, consumer products, healthcare, oil and gas, metals, power projects, restaurants, technology and telecommunications.

Mr. Cheng has provided restructuring advisory, interim management and crisis management services in both in- and out-of-court settings. He has prepared valuation, solvency and damages analyses for expert witness services. He has also assisted financial sponsors, boards of directors, companies and creditors in developing, evaluating and executing strategic and financing alternatives. Mr. Cheng has crafted corporate business plans, offering memorandums and restructuring proposals. In addition, he has managed daily liquidity needs and implemented cost-cutting initiatives and operational improvements for companies; conducted operational and financial due diligence, including valuations, business plan reviews and debt capacity analyses; and he has communicated with and managed constituencies and related parties during the restructuring process.

Mr. Cheng joined FTI Consulting with its acquisition of CDG Group, where he was a Director. He started his career with CDG Group.

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Robert Del Genio is a recognized leader in restructuring and mergers and acquisitions with over 40 years of experience. Mr. Del Genio is Co-Leader of the Corporate Finance and Restructuring segment's New York Metro Region and specializes in advising companies, lenders, creditors, corporate boards and equity sponsors across a diverse range of industries both domestically and internationally.

Mr. Del Genio has led numerous engagements where he has assisted clients on corporate restructurings and recapitalizations, valued and sold troubled companies both in and outside of Chapter 11, designed and evaluated financing packages and presentations to various types of lenders and equity investors and acted as financial advisor to boards of directors and principal shareholders in the purchase or sale of numerous businesses in a variety of businesses. He has also valued public and private acquisition candidates; structured financing for new businesses, acquisitions and management leveraged buyouts; performed risk/return analysis for new business ventures and provided expert testimony on issues related to valuations and corporate restructurings.

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Heath Gray specializes in advising public and private companies on large-scale transformations, turnarounds and transactions. Mr. Gray regularly serves in interim executive roles and as a senior advisor to management teams, boards of directors, special committees and private equity investors. He has extensive experience with complex international restructuring and mergers and acquisitions ("M&A") matters, crisis management and corporate governance.

Mr. Gray works with companies during periods of transformational change, rapid growth and financial distress. He has deep experience in leading M&A and financing processes, leading or managing operational and financial due diligence, developing business plans and financial projections, managing cash flow and liquidity and designing and implementing value creation and performance improvement initiatives, often in conjunction with financing, restructuring and M&A transactions.

Mr. Gray has advised companies on buy and sell-side M&A transactions, out-of-court financing and restructuring processes, bankruptcy cases, IPO readiness, takeover defense and shareholder activism and served in crisis management roles for companies facing severe liquidity challenges, fraud allegations and investigations by the United States Securities and Exchange Commission and the Department of Justice. He also has significant testimony experience as a financial advisor in formal restructuring proceedings.

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Dan Hugo specializes in turnaround, restructuring and interim management. Mr. Hugo has more than 20 years of experience, including industry expertise in transportation, construction, government contracting, banking, distribution, aggregates, manufacturing, home building, horticultural and metals, among other areas.

Mr. Hugo has led many comprehensive restructurings and successful Chapter 11 reorganizations, including serving in numerous interim management roles (CRO and CFO). Mr. Hugo has vast experience with complex domestic and international liquidity management, vendor management and negotiations and financial and operational improvement initiatives. He has developed financial models used in a variety of applications, including internal management and reporting, cash-flow management, executive and board review and delivery to external constituents. He has also led the creation of a variety of financial analyses, including regional, location and product-line profitability, pricing and contribution margin and equipment utilization and capacity, as well as various analyses related to acquisitions and divestitures.

Mr. Hugo led a team that was awarded the 2019 Large Transaction of the Year by the Turnaround Management Association for their work on Claires Stores. He was also awarded the M&A Advisor 40 Under 40 award in 2018. Mr. Hugo serves on the board of the Epilepsy Foundation Greater Chicago.

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Michael Katzenstein is Leader of the Interim Management Practice. Mr. Katzenstein specializes in in-court and out-of-court restructurings and has led engagements across many industries including traditional and new media, entertainment, technology, biotechnology, telecommunications and other subscriber-based businesses and investment funds. He has decades of cross-border restructuring experience and is called upon to advise in many of the largest and most complex matters.

Mr. Katzenstein's past roles have included chief restructuring officer, Chapter 11 financial advisor, board chair and member of executive and audit committees, post-effective liquidating trustee and monitor for the benefit of claimant trusts, among others.

Regularly called upon to lead and assist in implementing strategy for companies in financial or operating distress or transition, Mr. Katzenstein's clients include large- and mid-sized corporations and many major financial institutions and hedge funds. On many occasions, Mr. Katzenstein has served as a consulting or testifying witness on industry and corporate governance issues and has significant testimony experience, including in his capacity as CRO or financial advisor in restructuring proceedings. He began his career as a mergers, acquisitions and securities lawyer and was a partner in a New York law firm.

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Christine Kim has more than 25 years of experience advising on financial and operational restructurings on behalf of companies, lenders and other key stakeholders. She has industry expertise in consumer products, retail, business services, manufacturing, industrials, media and entertainment and education among other sectors.

Ms. Kim has led numerous engagements representing companies and lenders in in-court and out-of-court restructurings including advising on recapitalizations, developing strategic alternatives and business plans, implementing cost rationalizations and improving liquidity conditions.

A representative list of Ms. Kim's client experience includes Production Resources Group, VER Technologies, Catalina Marketing, Neiman Marcus Group, Francesca's, Aerosoles, Charming Charlie, WIS International, Noranda Aluminum, Sequa Corporation, B&H Education, Verso Corporation, Millennial Brands, Edmentum, RadioShack, Expert Global Solutions, EduK Group, LodgeNet Interactive, TCI College, The Cooper Union, New York City Ballet, Provo Craft & Novelty, RHI Entertainment, Corvest Promotional Products, Sharper Image, Steve & Barry's, Global Home Products, NABI Bus, Loral Space & Communications and IMG Worldwide.

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Marty Kuehne specializes in helping clients achieve and sustain organizational effectiveness through the management, alignment and development of high performing senior management teams, including executive compensation plan development, talent assessment, executive coaching and leadership development. During a career spanning almost 40 years, Mr. Kuehne has developed extensive expertise in maximizing the potential of people, business processes and Human Resource (“HR”) programs to produce superior business results.

Prior to joining FTI Consulting, Mr. Kuehne was a Managing Director at Seabury Consulting at Accenture where he focused on workforce planning & analytics, talent and organization and executive compensation.

He also founded Wise Fool, a consulting firm dedicated to executive coaching, sales leadership strategy and the overall HR restructuring for companies requiring transformation. Before this, he was the Founder and CEO of Organizational Concepts International (OCI), a human resources and management consulting firm.

Mr. Kuehne has held senior positions at American Express, Wells Fargo and Northwest Airlines with responsibility for compensation, benefits, organizational design with significant interface with the board of directors.

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Tim McDonagh is a trusted advisor to C-suites and Boards of Directors and specializes in complex, high-stake engagements. He has a track record of success in managing multiple constituencies and driving results in the most difficult situations. He has broad industry expertise including retail, automotive, media, financial services, distribution, utilities, chemicals and manufacturing.

Mr. McDonagh has deep experience assisting senior management teams and various stakeholders in assessing and reviewing business plans; preparing financial models, projections and cash flow models; managing liquidity and working capital; driving processes to sell businesses or underperforming assets and securing financing.

He has served on many high-profile engagements including Southeastern Grocers, Aeropostale, Delphi Corporation, LyondellBasell, CIT Group, Residential Capital, Vertis Communications, a $6 billion media company, a $600 million auto part remanufacturer, The Puerto Rico Electrical Power Authority, Eastman Kodak Company, Bluestem Brands, The Great Atlantic & Pacific Tea Company (“A&P”), The Children’s Place, RadioShack and Circuit City. In addition, Mr. McDonagh has served in interim management roles, including as interim CFO.

Many of Mr. McDonagh’s engagements have won awards from the *Turnaround Management Association, M&A Advisor, Association of Management Consulting Firms* and others. In 2018, Mr. McDonagh was selected by the *American Bankruptcy Institute* as one of the 40 Under 40 Emerging Leaders in Insolvency.

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Shannon Stucky Pritchett serves as Global Co-Head of the People & Transformation practice within the Strategic Communications segment of FTI Consulting. Based in Chicago, Ms. Stucky Pritchett specializes in developing and executing communications and change management strategies that accelerate transformation and build confidence in the organization’s leadership and future. She has worked with a wide range of organizations in change situations, including financial and organizational restructurings, post-emergence transformation, cost and liquidity management and other strategic shifts.

While her work is varied, the key objectives in all of Ms. Stucky Pritchett’s engagements are to protect business continuity and productivity, retain key talent and protect stakeholder relationships. The resulting strategies ensure key stakeholders — which may include employees, customers, suppliers, media, investors, regulators and/or elected officials — receive timely, accurate and consistent information.

She was named among Consulting Magazine's Rising Stars of the Profession and received M&A Advisor's Emerging Leaders Award.

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Rachel Chesley provides strategic communications counsel to companies, boards of directors, lenders, creditors and buyers as they prepare for, execute and emerge from financial restructuring or reorganization. Ms. Chesley frequently leads complex mandates involving international operations, workforce reductions, litigation related cases and/or transactions executed through a 363 sale process. In these cases, strategic planning and communications tactics are used to frame the client's actions within the context of its stated goals, ensuring that messages reach stakeholders in order to preserve value and maintain business continuity. She is based in New York and has been recognized as a leading financial communications expert by M&A Advisor, Business Insider, Consulting Magazine and PR Week.

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Michael O'Hara is a Managing Director and U.S. Co-Head of the Debt Advisory & Restructuring Group at Jefferies. Prior to Jefferies in September 2020, he was a Partner in the Restructuring and Special Situations Group at PJT Partners and Blackstone. At PJT Partners, Michael assisted in advising on a variety of restructuring and special situation assignments for companies, creditors, corporate board committees and acquirers and sellers of distressed assets.

Michael has served as a guest lecturer at the University of Chicago Booth School, Columbia Business School and the Wharton School at the University of Pennsylvania. Before joining PJT, Michael worked in the M&A Groups at Wasserstein Perella & Co. and Stephens Inc. Michael holds a BS in Finance from Georgetown University and an MBA from Columbia Business School.

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He has 16 years of experience working in finance and capital markets including as part of the Investment Banking Team at Ducera Partners and Proprietary Trading Group at RBC Capital. Paul has been a panelist and guest speaker at New York University's Stern School of Business, Columbia Business School, and Columbia Law School discussing topics related to distressed investing and restructurings.

Paul holds a BS in Business from New York University's Stern School of Business and received his MBA from INSEAD in Fontainebleau, France and Singapore.

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David Kurtz is Vice Chairman of Investment Banking and Global Head of Restructuring & Capital Solutions at Lazard and is recognized as one of the foremost restructuring professionals in the country. David has advised on some of the largest and most complicated restructurings as both an attorney and investment banker over the course of his 40+ year career.

He has extensive experience representing major U.S. and international companies in- and out-of-court, as well as buyers and sellers of assets in distressed situations. He also has extensive experience advising boards of directors, and generally representing domestic and international debtors and creditors in work-out, insolvency, restructuring and liability management matters. He has handled matters for clients in industries as varied as retail, manufacturing, technology, transportation, power & energy, media and real estate, among others.

Prior to joining Lazard in 2002, David was a senior partner in the Restructuring Group at Skadden, Arps, Slate, Meagher & Flom.

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Tyler Cowan is Managing Director and Co-Head of Restructuring & Capital Solutions North America Group at Lazard. With more than 18 years of experience, Tyler has advised companies, creditors and sponsors in a variety of liability management, restructuring, capital raising, merger and acquisition and corporate finance assignments in a wide range of industries.

Tyler's notable liability management engagements include advising Blackboard, J.Crew, Neiman Marcus, Peabody Energy, Macy's, iFIT Health & Fitness and Westgate Resorts, among others, while his notable in-court restructuring experience includes advising 24 Hour Fitness, Belk, Cengage Learning, Chassix, Claire's Stores, Dex Media (formerly R.H. Donnelly), FirstEnergy Solutions, Forever 21, The Great Atlantic & Pacific Tea Company, J.Crew, Local Insight Media, Longview Power / Mepco, Neiman Marcus, Peabody Energy, USEC and Westmoreland Resource Partners, among others. Concurrent with his various engagements, Tyler has raised billions of dollars of capital for his clients, as well as advised on a broad range of mergers, acquisitions and divestitures.

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Mike's notable engagements include advising advising Belk, Blackboard, Diamond Offshore, Express, the secured lenders of Foresight Energy, iFIT Health & Fitness, J.Crew, JCPenney, Longview Power/ Mepco, Neiman Marcus, Nine West, Patriot Coal, the secured lenders of Tops Friendly Markets and The Great Atlantic & Pacific Tea Company, among others.

Prior to joining Lazard in 2015, Mike was an Associate in the Restructuring Group at Kirkland & Ellis LLP.

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Adam Paul is a partner in Mayer Brown's Chicago office and co-leads the firm's Global Restructuring practice. He has extensive experience representing both debtor and creditor clients in complex U.S. and non-U.S. reorganizations, both in- and out-of-court. He also advises boards of directors and senior officers regarding fiduciary duties and restructuring strategies. In addition to his general restructuring work, Adam has significant experience in bankruptcies involving mass tort and legacy liabilities. Adam has been included in *Chambers USA*, *America's Leading Lawyers for Business*, *IFLR1000* and *The Legal 500*. Adam's work frequently wins deal of the year awards at leading restructuring awards programs, such as those organized by the Turnaround Management Association, International Financial Law Review, Global Restructuring Review and The American Lawyer.

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Lucy F. Kweskin, a Restructuring partner in Mayer Brown's New York office, advises on all stages of corporate restructurings (both in- and out-of-court) with significant experience with forbearance agreements, foreclosures, restructuring support agreements, debtor-in-possession financing, 363 sales and Chapter 11 plans. Lucy frequently litigates bankruptcy-related disputes concerning valuation, make-whole claims, inter-creditor issues, fraudulent transfers, recharacterization, veil piercing and breaches of fiduciary duty. Lucy represents stakeholders across the capital structure including debtors, lenders distressed acquirers, official committees of unsecured creditors, litigation financiers and landlords.

Lucy graduated from Columbia Law School, where she was a James Kent Scholar, and has a B.S. in Economics from the Wharton School at the University of Pennsylvania. During law school, she interned for the Honorable Robert E. Gerber of the United States Bankruptcy Court for the Southern District of New York. She currently teaches an Advanced Bankruptcy course at Columbia Law School.

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Daniel Shamah is a premier restructuring lawyer who is universally lauded by peers and clients for his expertise in complex restructuring and insolvency matters. Daniel's skillset is unique. Not only is he adept at conventional bankruptcy and restructuring proceedings, he is also an experienced litigator and handles disputes surrounding some of the most complex commercial and financial instruments across a broad range of industries and practices. Because of Daniel's creative approach and exceptional knowledge base, leading financial institutions, private equity sponsors, hedge funds and public and private companies call on him to help them navigate a host of bankruptcy and restructuring issues.

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Matthew Kremer is a financial restructuring specialist who represents debtors, ad hoc creditor groups, individual creditors and other parties-in-interest in Chapter 11 reorganizations, out-of-court restructurings and bankruptcy litigation. Matthew has deep restructuring experience in a wide array of industries, including energy, retail, telecommunications and marine contracting. Over the past five years, Matthew has served a lead role in the O'Melveny team representing the Government of Puerto Rico in the most complex municipal bankruptcy in history. In this role, Matthew continues to advise the Government of Puerto Rico, in all aspects of its ongoing restructuring efforts, including leading the effort to develop out-of-court restructuring plans for several public corporations of the Commonwealth.

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Chris has assisted numerous large corporations both inside and outside Chapter 11. He has also assisted numerous investors in, and acquirers of, distressed assets. Chris also often assists both institutional and alternative lenders in workouts and other situations. He earned his JD degree from the University of Wisconsin Law School, where he graduated cum laude, Order of the Coif.

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Andrew M. Parlen is a Partner in the Restructuring department who represents public and private companies, ad hoc creditor groups and investors in a variety of distressed situations — including out-of-court restructurings, pre-packaged and pre-arranged Chapter 11 reorganizations, debtor-in-possession financings and acquisitions of distressed companies. Andrew's recent company representations include Revlon, Hexion and Verso Corporation. His recent creditor matters include FirstEnergy Solutions, Covia Holdings Corporation and GenOn. Andrew has been recognized by Chambers USA, mentioned on Lawdragon's inaugural list of "500 Leading U.S. Bankruptcy & Restructuring Lawyers, named a "Rising Star" according to IFLR1000, *Law360* and *New York Law Journal*, called a "Next Generation Lawyer" in The Legal 500 and "Outstanding Young Restructuring Lawyer" by Turnarounds & Workouts. Additionally, Andrew participates in the NextGen Leadership Program of the International Insolvency Institute.

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Grace C. Hotz is an Associate in the Restructuring department. Her practice focuses primarily on creditor groups, individual creditors, debtors and distressed investment funds in Chapter 11 cases; out-of-court restructurings; bankruptcy-related acquisitions and cross border matters. Grace's most recent creditor-side representations include Mallinckrodt, Chief Power, Denbury Inc., Country Fresh, Dean Foods and Windstream. Her most recent debtor-side engagements include The Collegiate Churches of New York, Petra Diamonds, McGraw Hill, Pioneer Energy Services Corporation and Preferred Sands. Grace also has recent sponsor-side experience with matters involving Alex and Ani and Guitar Center. In law school at Northwestern University, Grace served as a Managing Notes Editor of the *Journal of Technology and Intellectual Property*.

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Prior to joining PJT Partners, Steve worked at Blackstone for 17 years, serving as a Senior Managing Director. Previously, Steve was a partner in Ernst & Young's Restructuring Group.

Steve is a Fellow of the American College of Bankruptcy, a frequent lecturer on restructuring related topics at New York University and serves on its Board of Overseers. Additionally, he serves on the boards of Her Justice and the University at Albany School of Business. Steve received an MBA in finance from NYU's Stern School of Business and a BS in accounting from the University at Albany.

Amongst Steve's most notable assignments are Abitibi Bowater Inc., Caesars Entertainment, Delphi Corporation, Energy Future Holdings, Enron Corporation, General Motors, Goodyear Tire & Rubber, iHeart Radio / ClearChannel Outdoor, Intelsat S.A., Kerzner International, Marvel Entertainment, Pacific Gas & Electric (PG&E), Puerto Rico Federal Oversight Board & Management Board, R.H Macy & Co., Washington Mutual and Xerox.

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Susheel Kirpalani is a Partner and Chairperson of the firm's Bankruptcy and Restructuring Group. Susheel has served as a court-appointed examiner and mediator and has broad experience in insolvency-related litigation and emerging issues in bankruptcy law. Among other historic representations, including Enron and Lehman Brothers, he played a key role in the successful defense of the private equity sponsor in the action by the LyondellBasell creditors' trust. In international matters, Susheel represented Dubai World in drafting Dubai's bankruptcy legislation for public decree companies and assisted the Government of Antigua & Barbuda with legislation designed to stave off the collapse of the nation's airline. Susheel led the firm's engagements on behalf of bondholders in Puerto Rico, including providing testimony before Congress regarding the fairness of the restructuring title of the Puerto Rico Oversight, Management and Economic Stability Act, which was thereafter enacted into law. Susheel is a fellow in the American College of Bankruptcy and a conferee of the National Bankruptcy Conference.

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Over the last 25 years, James Tecce has gained extensive experience representing both creditors and debtors in some of the nation's largest and most complex Chapter 11 cases and in commercial litigation more generally involving financial institutions and lending arrangements. He has litigated a wide range of contested matters in Bankruptcy Courts such as DIP financing, exclusivity and confirmation contests and has represented clients like General Motors LLC, Peabody Energy Corp., Toys Labuan (Holding) Limited, Intelsat Jackson Holdings S.A. and the Official Committee of Unsecured Creditors of Lehman Brothers Holdings Inc. He also has prosecuted and defended against appeals from Bankruptcy Court decisions before the United States District Courts and the United States Circuit Courts of Appeals. James has been ranked among leading Bankruptcy Restructuring lawyers in *Chambers USA,* Best Lawyers in America in *U.S. News and World Report* and a Litigation Star in *Benchmark Litigation*.

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Ben Finestone was ranked as a leading New York Bankruptcy/Restructuring individual by *Chambers*

USA (2013–2021), was named a National Practice Area Star [Bankruptcy] and Litigation Star by Benchmark Litigation (2022) and was repeatedly recognized in *Law.com's* "Litigator of the Week" publication, including for trial victories against Citibank and concerning Sanchez Energy on February 19 and March 19, 2021, respectively. Ben also has been recognized as a "Recommended Lawyer" by *Legal 500*, a "Super Lawyer" by *New York Metro Super Lawyers* (2013–2021), was one of 12 attorneys nationwide named as one of *Turnarounds & Workouts'* "Outstanding Young Restructuring Lawyers" in 2011 and has received Turnaround Awards by the M&A Advisor in 2013 and 2018. In *Chambers*, clients stated: "He's phenomenal. Everyone is taken aback at how good he is." Ben is described as "super smart and motivated to find creative ways to make arguments that get good results for clients."

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Deborah Newman has over 18 years of experience in high-impact bankruptcy and distressed debt related litigation. She has represented institutional investors, indenture trustees, official and ad hoc committees and debtors in possession in the full range of complex litigation matters that arise during the course of Chapter 11 restructurings, cross-border insolvencies and other bankruptcy contexts. Deborah has been involved in some of the most cutting-edge issues in bankruptcy, including the treatment of original issue discount under the Bankruptcy Code, the appropriate cram-down interest rate for a secured creditor, individual creditors' rights to pursue fraudulent transfer actions in spite of a debtor's bankruptcy filing and the scope of the bankruptcy code's fraudulent transfer safe harbor. Deborah is currently lead counsel for two litigation trusts in high-stakes litigation seeking hundreds of millions of dollars. Deborah was named a "Rising Star" for Bankruptcy Litigation in 2016 by *Law 360*.

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Gregg M. Galardi, Head of the firm's Business Restructuring department. Gregg has broad global experience and has represented some of the most well-known debtors and distressed borrowers, in a wide variety of industries. Gregg has more than 25 years of experience in both in-court and out-of-court restructurings and reorganizations. He also serves the firm's sponsor client base and portfolio company clients in distressed mergers and acquisitions and special situations.

Gregg is a Fellow of the American College of Bankruptcy and was recently awarded *Law360's* "Bankruptcy MVP" and *The Deal's* "Debtor Counsel of the Year, Middle Market." Gregg formerly served as an adjunct professor at Vanderbilt Law School and is a frequent speaker on Chapter 11 issues.

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Ryan Preston Dahl, Partner in the Business Restructuring Group with extensive experience representing publicly- and privately held debtors, distressed investors and financial sponsors in special situations, out-of-court restructurings and distressed acquisitions and in-court Chapter 11 processes through pre-packaged, pre-arranged and traditional restructurings. His practice also includes a broad range of transactional and litigation matters across a number of industries including automotive, technology, retail, media, gaming, manufacturing, professional services and financial services.

Most recently, Ryan was named among *Lawdragon*'s 500 Leading Global Restructuring & Insolvency Lawyers in 2020 and *Turnarounds & Workouts*' "Outstanding Young Restructuring Lawyer" for 2018, as well as receiving the *Rising Star* award from Euromoney Legal Media Group and the *Law360* 40 Under 40 award, also in 2018.

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Cristine Pirro Schwarzman, Restructuring Partner in Ropes & Gray's New York office. She has represented some of the most well-known debtors in the world, and in 2020 was named "40 Under 40" by the American Bankruptcy Institute, a "Rising Star" by *Private Debtor Investor* and a "Top U.S.A. Dealmaker" by the Global M&A Network. Prior to joining Ropes & Gray, she worked as the law clerk for Chief Judge Gonzalez of the Southern District of New York and then joined the restructuring group of another preeminent New York law firm. Cristine joined Ropes & Gray's restructuring practice to continue her representation of debtors, distressed borrowers and investors, including private equity sponsors in connection with out-of-court restructurings and Chapter 11 cases. She also advises boards of directors and senior management of distressed companies regarding fiduciary duties and corporate governance.

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Daniel Gwen, Associate in the Business Restructuring Group in Ropes & Gray's New York office. Daniel has extensive experience representing major companies and stakeholders in all aspects of complex corporate restructurings. This includes Chapter 11 cases, out-of-court restructurings and special situations. Daniel has been heavily involved in some of the most complex Chapter 11 filings in recent history and has a broad range of experience across numerous industries.

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Tom Califano is a partner in Sidley Austin's New York office and a member of the firm's Restructuring Group. He represents large private and public companies in distress both in and out of court, buyers of distressed companies and significant creditor constituencies.

Tom has been recommended by The Legal 500 United States for his "excellent reputation across all aspects of in- and out-of-court restructurings." He has also been repeatedly recognized for his work in bankruptcy and restructuring by Chambers USA, where he is described as "an aggressive and fierce advocate for his clients" with an "expertise in advising financially troubled companies and buyers of distressed assets." Tom is listed in The Best Lawyers in America and has been named a New York Super Lawyer.

Prior to joining Sidley, Tom was the global Co-chair and U.S. Chair of the restructuring group at another global law firm. Tom earned a BA and JD from St. John's University where he was a recipient of the St. Thomas More Scholarship.

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Ryan Fink is an associate in Sidley Austin's Chicago office and a member of the firm's Restructuring Group. His practice focuses on all aspects of corporate restructuring, including bankruptcy proceedings, out of court reorganizations and workouts, distressed debt acquisitions and bankruptcy-related litigation.

Prior to joining Sidley, Ryan was a high school Lincoln-Douglas debate coach, working with and mentoring several national champions.

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Paul focuses on advising U.S. and transnational businesses on Chapter 11 reorganizations, out-of-court restructurings, secured financings, debtor-in-possession loans, distressed acquisitions and sales and investments in troubled companies. He has led high-profile restructurings in most major industries, including retail, health care, oil and gas, shipping, mining, airlines, energy, publishing, telecom, satellite communications and real estate.

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Lisa Laukitis regularly represents corporations, secured and unsecured creditors and private equity funds, advising on out-of-court restructurings and Chapter 11 bankruptcies. Lisa also handles distressed mergers and acquisitions as well as various financing arrangements, and she litigates disputes related to the use of cash collateral, DIP financings, sales under Section 363 of the Bankruptcy Code, modifications of labor agreements and retiree benefits and plan confirmations.

Lisa has experience in a wide variety of industries, including metals and mining, automotive, general manufacturing, energy, telecommunications, cable, retail and shipping. She also regularly represents various private equity and hedge funds in connection with their investments in distressed companies.

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Liz Downing has advised debtors, creditors, equity sponsors, sellers, purchasers and other parties-in-interest in all stages of complex restructuring transactions, including pre-packaged, pre-arranged and traditional Chapter 11 cases, out-of-court workouts, distressed acquisitions and cross-border proceedings. Liz has experience counseling clients across a wide variety of industries, including health care, energy, financial services, shipping and retail.

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Marco is a dual citizen of the U.S. and Italy and has lived in the United States and the United Kingdom, working across multiple geographies. Marco earned his bachelor's degree in economics from Princeton University and his MBA from Columbia Business School.

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David is recognized by the top legal rankings and research firms. He was recognized by Chambers USA 2021 in Restructuring/Bankruptcy for New York, and under his leadership, the New York practice gained the "Highly Regarded" Band 1 recognition. Clients praised him as "one of the best debtor-side restructuring lawyers we have ever worked with at any firm" and noted that David is "a great thought partner in complex restructurings and skilled at representing both companies and creditors."

David has received recognition from Turnaround & Workouts, Legal 500 U.S., Best Lawyers in America© and New York Super Lawyers.

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Co-head of Vinson & Elkins' Restructuring & Reorganization group, Bill Wallander has led a robust restructuring practice which has achieved national recognition.

Client compliments include: "Bill is a big-picture thinker and seeks strategic solutions to disputes and problems." "He uses a lot of energy and focus to achieve a client's goals." "He is a phenomenal lawyer." Bill led the team which captured the Turnaround Management Association's ("TMA") 2021 Turnaround/Transaction of the Year Award, with the Tuesday Morning bankruptcy case.

Bill is recognized by Chambers USA, Legal 500 U.S., Who's Who Legal, Best Lawyers in America© and Lawdragon 500. Bill is a Fellow of the American College of Bankruptcy, a director of the American College of Bankruptcy Foundation and an Executive Committee member of the John C. Ford American Inn of Court.

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An accomplished lawyer with more than 30 years of experience, Paul Heath is a partner in the Restructuring & Reorganization practice group. During his career, Paul has handled a multitude of complex Chapter 11 bankruptcy cases and out-of-court restructuring matters.

He regularly represents public and private companies and advises their respective board of directors and senior management on developing solutions for reorganizing capital structures and business operations. His clients include companies in a range of industries, including energy, distribution, manufacturing, retail and telecommunications. He represents senior secured agents and lenders as well as strategic and financial purchasers of assets from financially distressed companies.

Paul's clients have great things to say: "Paul is a phenomenal lawyer;" "he is a tremendous resource in the bankruptcy arena." Paul has been recognized for his work by *Chambers USA, Who's Who Legal, Legal 500, Best Lawyers in America© and Texas Super Lawyers.*

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Her engagements have spanned various industries, including financial services, pharmaceutical, logistics, shipping, grocery, energy, oil and gas, digital marketing, manufacturing, real estate and retail.

Her recent in-court representations have included RentPath Holdings and its affiliates, one of the nation's largest apartment rental and digital marketing solutions companies, in their pre-arranged Chapter 11 cases and sale to Redfin Corporation for $608 million, syncreon Group Holdings B.V. and its affiliates, a leading global logistics services provider, in its groundbreaking, cross-border balance sheet restructuring involving approximately $1.1 billion of funded debt, which was recognized as the 2020 International Company Transaction of the Year by the Turnaround Management Association, an ad hoc group of lenders in the cross-border restructuring of KCA Deutag, a global driller and engineering contractor and Centerbridge Capital Partners and its affiliates, as sponsor, in the chapter 11 cases of CraftWorks Parent and its subsidiaries, a restaurant and brewery operator.

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Gary is an Adjunct Professor at Cardozo School of Law. He is also a Fellow of the American College of Bankruptcy. Gary is consistently ranked in the field of Bankruptcy/Restructuring in *Chambers Global*, *Chambers USA* and *Legal 500 US*. He is described by commentators in Chambers USA as a "talented bankruptcy attorney" and a "confident, experienced and calm" presence on complicated transactions.

Most recently, Gary has led and leading numerous high-profile restructurings, including, All Year Holdings Limited, Scandinavian Airlines, Brooks Brothers Group, Inc., Skillsoft Corporation, Briggs & Stratton Corporation, Speedcast International Limited, Halcón Resources Corporation, Insys Therapeutics, Inc. and Catalina Marketing Corporation, among others.

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