The Impact of Recent Litigation and Trends on Bankruptcy Lawyers and Their Clients

Paul H. Zumbro

Partner

Cravath, Swaine & Moore LLP

ASPATORE

Notable Trends in Bankruptcy and Restructuring Law

For a bankruptcy practitioner, when things are going well with the economy, that means things are bad for your practice. The economy is currently showing signs of recovery, and the capital markets are showing signs of life, particularly the high-yield market. While that is good for the economy and businesses in general, it is not necessarily good for the business of a bankruptcy professional.

One recent trend in bankruptcy and restructuring law is the dramatic falloff in bankruptcy work in 2010. This is largely the result of a bond default rate that is considerably lower—well below the historic average, in fact—this year than it was in 2009, when it was well above the historic average. This is the result of a variety of factors, including the continuing low interest rate environment and the reopening of the capital markets, particularly the high-yield market. The high-yield market is very hot right now, providing a refinancing alternative to many businesses. Some companies are too small to access that market, though, and are still having trouble as a result.

Another trend has emerged over the past year or so with respect to bank loans. Increasingly, lenders will agree to push out the maturity date of a loan for a couple of years, enabling companies to use these loan extensions as a partial refinancing mechanism. While these companies generally are unable to push out the term of the entire loan, they can often push out a big portion of it. Borrowers are taking advantage of these "amend-and-extend" transactions to chip away at that maturity wall—a practice that has, in some ways, delayed the day of reckoning for many companies. There are, however, many companies that are so overleveraged—because of a leveraged buyout that has strapped the company with debt, for example—that a high-yield refinancing transaction or an amend-and-extend transaction will not provide a permanent or complete solution.

Another potential trend is in the area of municipalities and local governments that are facing distressed situations. A growing number of these government entities are contemplating Chapter 9 filings. Whether that trend materializes is anyone's guess, because when dealing with a municipality, in addition to the normal financial complexities, the political overlay makes the situation much more complicated and sometimes quite difficult to resolve. A gating item is often legislative authorization for a bankruptcy filing. Unlike a corporate debtor, a municipality needs specific legislative authorization to file for bankruptcy, and certain states have recently denied the requests of a municipality for such authorization. Also, recent Chapter 9 experiences such as that of Vallejo, California, have shown that the process can be quite expensive, and a Chapter 9 filing is not a magic bullet that will solve all a municipality's problems.

It should also be noted that the Madoff and Lehman Brothers cases are still working their way through the system. The *Lehman* case, *In re Lehman Brothers Holdings Inc., et al.*, No. 08-13555, 2010 WL 481873 (JMP) (Bankr. S.D.N.Y.), began in 2008, but it involves such a huge and complicated situation that it is still unresolved and will remain that way for some time. Likewise, the *Madoff* case, *In re Bernard L. Madoff*, No. 08-01789, 2010 WL 4845737 (Bankr. S.D.N.Y.), is keeping many professionals busy because it had such a widespread impact on a variety of people and institutions. As we reach the two-year anniversary of the Madoff bankruptcy, the trustee has been busy filing a wide variety of claw-back and other claims, and the resolution of those cases will take a considerable amount of time.

Recent Decisions in Bankruptcy and Restructuring Law

One bankruptcy case that received considerable exposure in the press this past year was the *Philadelphia Newspapers* decision, *In re Philadelphia Newspapers*, LLC, 599 F.3d 298 (3rd Cir. 2010). At issue in this case was the ability of secured creditors to credit bid their debt in the context of a restructuring plan, as opposed to a Section 363 sale. The Third Circuit held that a secured creditor's right to credit bid in connection with the sale of its collateral in a Chapter 11 plan is not guaranteed by the Bankruptcy Code in the event that the plan provides for the "indubitable equivalent" of the creditor's claim. Many commentators predicted that the case would seriously undermine secured creditors' rights. While it was an interesting case, I am not sure it will have much of an ongoing or lasting impact, mainly because means are available to secured creditors to structure around the decision. For example, secured creditors can impose limits on debtor plans through debtor-in-possession lending and cash collateral agreements or use creative financing, such as short-term loans, to enable them to cash bid with the same effect as credit bidding. In fact, the secured creditors did just that in the *Philadelphia Newspapers* case and were ultimately the winning bidders in the auction. And so, while commentators initially characterized the ruling as a major blow to secured creditors, I do not think it will have as big of an impact as others thought it might when it was first decided.

A case that may have a significant impact is the *Lehman Brothers v. Barclays* dispute, *Lehman Brothers Holdings Inc. v. Barclays Capital Inc.*, Adv. Proc. No. 09-01731 (JMP) (Bankr. S.D.N.Y.). In this case, the Lehman bankruptcy estate seeks to revisit certain aspects of the asset sale to Barclays that was completed in the first week after the Lehman bankruptcy. Lehman argued that Barclays failed to disclose information that was material to the sale, and asked the bankruptcy court to reopen the transaction for examination in light of the alleged previously undisclosed facts. This is a decision that a number of people are interested in, because from a purchaser's perspective, it is very important to know there is finality to the proceedings in a bankruptcy asset sale. The general rule is that you cannot reopen a bankruptcy sale that has been approved by the bankruptcy court, but the facts of this case may allow Lehman to reverse the earlier decision and reassess the value of the deal, which would be a significant development. Clearly, the world is a very different place today than it was during the week in late 2008 when the Lehman asset sale took place. The notion that this type of sale is subject to reexamination in hindsight is very problematic from a purchaser's perspective. If Lehman is successful in reopening or adjusting some of the terms of that sale through litigation, that could cause significant concern to buyers in future bankruptcy transactions. The trial in this case concluded this summer, but a decision has not yet been rendered.

The *Tousa* decision, *Official Committee of Unsecured Creditors of Tousa Inc. v. Citicorp N. Am. Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009), handed down by a Florida bankruptcy court, also got a lot of attention this year. Although again, the impact of that case may have been considerably overstated. Some people seem to have misread that case to mean that upstream guarantees from subsidiaries are always going to be avoided in the event of a bankruptcy filing. While it is true that there is always some fraudulent transfer risk with these types of guarantees, I believe the facts in the *Tousa* case made the result less surprising or as generally applicable as people seem to think. As is often the case with court decisions that grab headlines, the facts in *Tousa* were particularly bad—the subsidiaries that provided the upstream guarantees that were avoided were not liable on the underlying litigation that was settled with the proceeds of the guaranteed loans, and according to the opinion, they were demonstrably insolvent at the time the guarantees were entered into. The other part of the decision that got a lot of attention—the part dealing with contractual fraudulent transfer savings clauses—was mere dicta (i.e., technically irrelevant to the court's ruling in the case). Because of this (and the particularly bad facts in *Tousa*), I think the impact of this case will probably turn out to be overstated in the long run.

Changing Strategies and New Cases

I have found that the specific details of the bankruptcy and restructuring cases we are working on are not necessarily affected by the overall trends in this area. Consequently, I do not think there have been any significant changes to the way we approach the issues that arise in our cases. I also do not think these trends affect how our practice is conducted in terms of the cases we are actually working on, which cover a wide variety of issues. We may be helping clients deal with a Madoff-type settlement or a merger and acquisition transaction where there is a bankruptcy component, but it is not necessarily affected by overall bankruptcy trends.

We have recently been engaged to advise the City Council of Harrisburg, Pennsylvania, in considering their debt restructuring alternatives, which is one example of the recent trend involving municipality restructurings alluded to above.

I have found that there were fewer mega-bankruptcy cases in 2010 than there were in 2009. I spent a lot of my time last year on the *Lyondell* bankruptcy case, *In re Lyondell Chemical Company, et al.*, Case No. 09-10023 (Bankr. S.D.N.Y.), which was a huge Chapter 11 reorganization. However, I dealt with fewer such cases in 2010. Obviously, there is still some considerable impact and fallout from the big financial services cases (e.g., the *Lehman*- and *Madoff*-related cases) that are still percolating through the system. However, there are fewer mega-bankruptcy cases this year, and fewer filed cases overall.

We have been doing more out-of-court restructurings than court filings this year. Although it depends on the facts of the case, it is almost always better to do an out-of-court restructuring (if you can) rather than going through the expense and difficulty of a court proceeding. We have also been doing a number of amend-and-extend transactions, where people are pushing balance sheet maturities off to avert the need for a restructuring, as previously noted.

New Legal Issues and Hurdles

Again, although I do not think the *Philadelphia Newspaper*s case is going to have as much of a long-term impact as people have suggested it might, this type of ruling demands a renewed awareness of the potential pitfalls those types of situations pose to secured creditors, and attention to transaction structuring and legal documentation to address the secured creditor rights impacted by the decision.

Another challenge for clients involves dealing with credit documents. There have been a lot of disputes in the last few years about collective action under credit facilities, specifically whether the majority of the lenders under a credit agreement has the right to direct the agent to consent to a sale, as in the *Chrysler* case, *In re Chrysler LLC*, Case No. 09-50002 (Bankr. S.D.N.Y.), or credit bid the debt. There has recently been some movement in the market to try to more specifically address these types of issues in credit agreements. I think these cases were correctly decided, as I believe the "majority rules" approach is what was intended by credit agreements. However, this concept is usually not made expressly clear in credit documents, and it would therefore be a good idea to make the documentation more expressly state the intention of the parties.

Finally, there has been a lot of litigation over conditional priority provisions, or "flip clauses," in the Lehman bankruptcy. These provisions change the default waterfall priority scheme in certain securitization transactions upon defined default events, including bankruptcy. While seemingly straightforward contractually, these flip clauses are at the center of some significant litigation in the Lehman bankruptcy. In one such action, the bankruptcy court ruled that the flip clause was an unenforceable *ipso facto* clause. The outcome here may affect (in ways that people find surprising) some of the mechanics of swap agreements going forward.

Looking to the Future

It is hard to say what the upcoming trends in this area will be, as we have seen that events can ripple in unexpected ways. For example, the impact of the European debt situation is hard to predict. Similarly, the domestic tax situation in the United States could have an impact on the capital markets—particularly the high-yield market, which has a tendency to be a little unpredictable and jumpy. Sometimes the markets react quickly in unexpected ways to macroeconomic developments. If the high-yield market were to shut down (or significantly slow down) for whatever reason (as we have seen happen in the past), that could have a big impact on companies that have refinancing needs.

As I have noted, there has been a lot of progress in terms of companies chipping away at the so-called "wall of maturity." The economy is improving, which should help the revenue side of the equation of companies meeting their debt service. However, if a shock were to occur that negatively affected the capital markets or shut them down again (similar to what happened in 2008 and 2009), companies' refinancing needs could become much more difficult (or impossible) to address, even if the revenue side is improving. If there are no debt markets available to allow companies to refinance their debt, that could cause real problems, particularly for companies that are highly leveraged. Simply put, one big shock could close the high-yield market, and that would be a big problem and could materially increase the number of corporate bankruptcy filings.

The low interest rate environment has been beneficial for refinancing, but that situation could also change—although I do not think that will happen anytime soon, given current macroeconomic policies. However, the availability of capital, as we have seen, could easily change.

Key Takeaways

- For the time being, the robust high-yield market and the availability of techniques such as the amend-and-extend transaction have enabled many companies to address their refinancing needs. However, a market disruption could occur quickly and unexpectedly, causing companies—particularly those that are highly leveraged—to run smack into the wall of maturity.

- Although it depends on the facts of the case, it is almost always better if you can do an out-of-court restructuring rather than going through the expense and difficulty of a court proceeding.

Paul H. Zumbro is a partner in Cravath, Swaine & Moore LLP's Corporate Department. His restructuring practice focuses principally on representing secured creditors in complex in-court and out-of-court restructurings, and draws on his extensive experience in leveraged finance. Prior to transitioning to a full-time restructuring practice, he had represented the financial sources in many of the most significant and complex leveraged buyout financing transactions over the past several years. Following the collapse of the credit markets, he advised the financing sources in a number of high-profile leveraged buyout transactions that encountered difficulties or collapsed. He has experience in all phases of capital raising and balance sheet restructurings, including out-of-court debt exchanges and debtor-in-possession financings, and is currently involved with a number of high-profile bankruptcy and restructuring matters.

Mr. Zumbro received a BA, cum laude and with distinction in the major, from Yale College and a JD from Columbia Law School, where he was a Stone Scholar. He joined Cravath in 1997 and became a partner in 2005. He is a member of the International Bar Association and the American Bankruptcy Institute, and is a member of the Reorganization and Workout Subcommittee of the International Bar Association's Insolvency, Restructuring, and Creditors' Rights Section. He is a frequent author and speaker on his areas of expertise.

Acknowledgment: *The author would like to thank Benjamin M. Smith, an associate in Cravath, Swaine & Moore LLP's Restructuring Group, for his help in preparing this chapter.*

First Printing, 2011
10 9 8 7 6 5 4 3 2 1

ASPATORE

www.Aspatore.com

Aspatore Books, a Thomson Reuters business, exclusively publishes C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. C-Level Business Intelligence™, as conceptualized and developed by Aspatore Books, provides professionals of all levels with proven business intelligence from industry insiders—direct and unfiltered insight from those who know it best—as opposed to third-party accounts offered by unknown authors and analysts. Aspatore Books is committed to publishing an innovative line of business and legal books, those which lay forth principles and offer insights that when employed, can have a direct financial impact on the reader's business objectives, whatever they may be. In essence, Aspatore publishes critical tools for all business professionals.

Inside the Minds

The *Inside the Minds* series provides readers of all levels with proven legal and business intelligence from C-Level executives and lawyers (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. Each chapter is comparable to a white paper or essay and is a future-oriented look at where an industry, profession, or topic is heading and the most important issues for future success. Each author has been selected based upon their experience and C-Level standing within the professional community. *Inside the Minds* was conceived in order to give readers actual insights into the leading minds of top lawyers and business executives worldwide, presenting an unprecedented look at various industries and professions.

ASPATORE