Legal overview of financial restructuring

Lesson 2

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Introduction

- In the first lesson we saw **financial restructuring as the exercise of fitting the right liability level in the balance sheet to match the asset value**
- While there are several solutions for the exercise there are **only two approaches to the process: *in court* and *out of court***
- ***In court* refers to a formal court supervised process** which bounds all the creditors, like the Ch. 11 of the Bankruptcy Code in the US
- ***Out of court* is about a voluntary agreement** between the firm and some of its creditor but not necessarily all
- Ch. 11 and in general all bankruptcy procedure are time consuming, highly expensive and have the risk to disrupt the business
- If an out of court cannot be achieved the firm may be forced into bankruptcy
- While the financial restructuring exercise of sharing the asset value among the different holders of interests can be seen a zero sum game, bankruptcy can easily turn it into a negative sum game

The out of court is the preferred options when feasible and effective

1

Out of court restructuring

Out of court restructuring

- In the cases in which just renegotiating the terms of the debt (interests rate, maturity, amortization) is not enough to solve the distress, some kind of **exchange** is to be arranged
- An exchange is a trade in which the original debt is exchanged with a mix of new debt (for a lower amount), equity securities and, potentially, cash
- The exchange will try to target the desired post restructuring capital structure

Example CO: pre restructuring

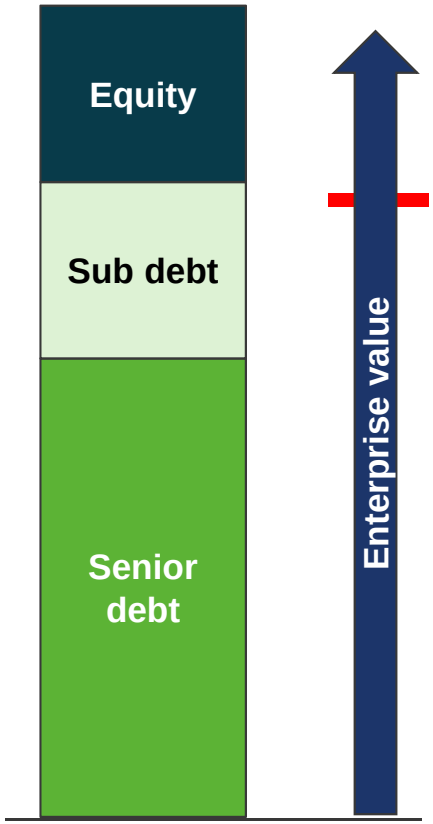
ASSETS		LIABILITIES	
Asset value	490	Debt	490
		EQUITY	
		Equity	0

Debt face value: 1200

Example CO: target

ASSETS		LIABILITIES	
Fixed assets	490	Debt	290
		EQUITY	
		Equity	200

The valuation of the firm determines the value to be distributed to stakeholders



Value break	Issues	Typical dynamics
❶ **On the cusp of value brake**	• Equity out of the money but still deeply involved • Banks close to whole but no influence • Yet limited pressure from liquidity	• Shareholders reluctant to let the business go • Covenant reset, debt rescheduling or restructuring depend on liquidity issues, with banks asking for equity injection • Working capital facilities could be provided by existing banks
❷ **Out of money**	• Equity out of the money and "sitting on the fence" • Banks suffering losses, recovery unclear, many parties joining the table • Pressing urgency from liquidity needs	• Business requires fundamental restructuring and liquidity • Subordinated debt holders with limited options, senior debt holders try to minimize write offs • New money as new investment and financing only super senior
❸ **Sticking plaster**	• Equity disinterested • Fierce discussions on recovery and potential litigation • Bankruptcy value destruction looming	• Untimely or inadequate reaction to adverse events • No material recovery expected • Bankruptcy proceeding likely alternative to debt restructuring

- **In a financial restructuring valuation is the object of significant negotiations and disputes since determines if a certain class of interests holder will receive a «slice of the cake»**

The post reorganization capital structure

- The post reorganization target capital structure is in many way arbitrary and subject to what is needed to satisfy the different stakeholders and the debt capacity and credit support provided by the firm
- In the example before, the old debt (1200M) is exchanged for a new debt (290M) and a number of new shares
- If the firm is not able to generate stable operating cash flow to serve debt than complete equitization of the old debt is advisable
- The number of new shares that are given to the debtholder will determine what value is left to old shareholders: for example if the firm had 100 shares and 10000 of new share are given to the debtholders, the old shareholders will be diluted to ~1% of the firm
- Note that in an out of court process the debtholder can voluntary accept to participate to the exchange but cannot alter the interests of non participating stakeholders, i.e. cannot force the expunging of the old shareholders which will maintain their shares

The participants to the process

- The participants will be determined by the capital structure to be restructure
- In case of loans made by a small group of lenders the participants are evident, in case of large syndicated loans usually there is an “agent” who is paid to perform such duties
- In case of bonds, a small but significant group of bondholders will form an informal committee
  - The committee have no fiduciary duties to other bondholders (in or out of the committee) and have no legal authority to bind them
  - Members of the committee can have different agendas and goals
  - The firm recognizes the “legitimacy” (i.e. worth negotiation with”) of the committee if they represent significant percentage of bondholders (>25%)
  - The committee usually will retain legal and financial advisors at the firm’s expenses
- Technically the legal representative of the bondholders is the indenture trustee (a bank acting in a custodial capacity) but:
  - The trustee will act only when it believes is on behalf of all or a specified percentage of bondholders
  - The trustee is extremely risk averse and will do only what they are obliged to do

Real life: bondholder committee

Rimrock, Oaktree Among Largest Waste Italia Bondholders, Creditor Committee Appoints Orrick, FA Pitches Next Week

Fri 19/02/2016 10:42
Relevant Documents:
3Q15 Earnings Presentation
2019 Bond Prospectus
Tear Sheet

A committee of Waste Italia's bondholders appointed Orrick as legal advisor and is looking for a financial advisor, according to sources familiar with the situation. Los Angeles-based Rimrock and Oaktree are among the Italian waste manager's largest bondholders, the sources said.

The committee represents approximately 40% of the Italian waste manager's €200 million notes, which are currently trading in the mid-20s.

Source: Reorg-Research

Real life: note trustee

Rickmers Maritime
Rickmers Trustee Manager Receives Letter From Noteholder Group Representative Wishing to Take 'Legal Action'

Relevant Documents:
Release

Rickmers Maritime's trustee manager, Rickmers Trust Management Pte. Ltd, has received a letter from Rajah & Tann Singapore LLP ("R&T"), which is acting as solicitors for certain noteholders of the S$100 million 8.45% notes due 2017, indicating that the group they represent "wish to directly take such legal steps and actions against the Trust to enforce repayment of the Notes, together with accrued interest."

Today's announcement details that the group is wishes to pursue legal action on the basis that DB International Trust (Singapore) Limited, the notes trustee, "failed to institute any action against the Issuer" following a written request from noteholders on Sept. 28 which argued that the notes were immediately repayable. The trustee-manager is validating the contents of the letter received.

If an event of default in has occurred and if a group representing at least 25% in principal of the notes outstanding gives notice, or if directed by a noteholder extraordinary resolution, the notes trustee will give notice to the trustee manager that the notes are due and payable. The release adds though that "No Noteholder shall be entitled to proceed against the Trust unless the Notes Trustee, having become bound to do so, fails to do within a reasonable period and such failure is continuing."

Thus far, the trustee manager has not received any notice from the notes trustee and R&T hasn't provided evidence that the trustee is bound to give notice.

Source: Reorg-Research

Implication of being on the bondholder committee for an investor

- First implication is that to sit on the committee, and therefor actively influence the restructuring discussion, an investor must have accumulated a significant quantity of bonds
- Second implication is that bondholders committee members will likely receive material non public information and will need di sign *a confidentiality agreement:*
  - The consequence of signing a confidentiality agreement is to become *restricted* from discussing non public info and from trading securities of the firm without disclosing the possession
  - To stay unrestricted committee members can decide that only their legal and financial advisors have access to non public info. Lawyers will then advise when the members become restricted
  - Once the committee becomes restricted it will stay so till the information are made public or the become non material
  - To mitigate risks, restricted parties can trade securities of the firm asking the counter-party to execute a document (*"big boy letter"*) which contains an acknowledgement that he is aware that the counter-party is in possess of non public information and a waiver of claims the nonrestricted might have under security laws

Real life: going private

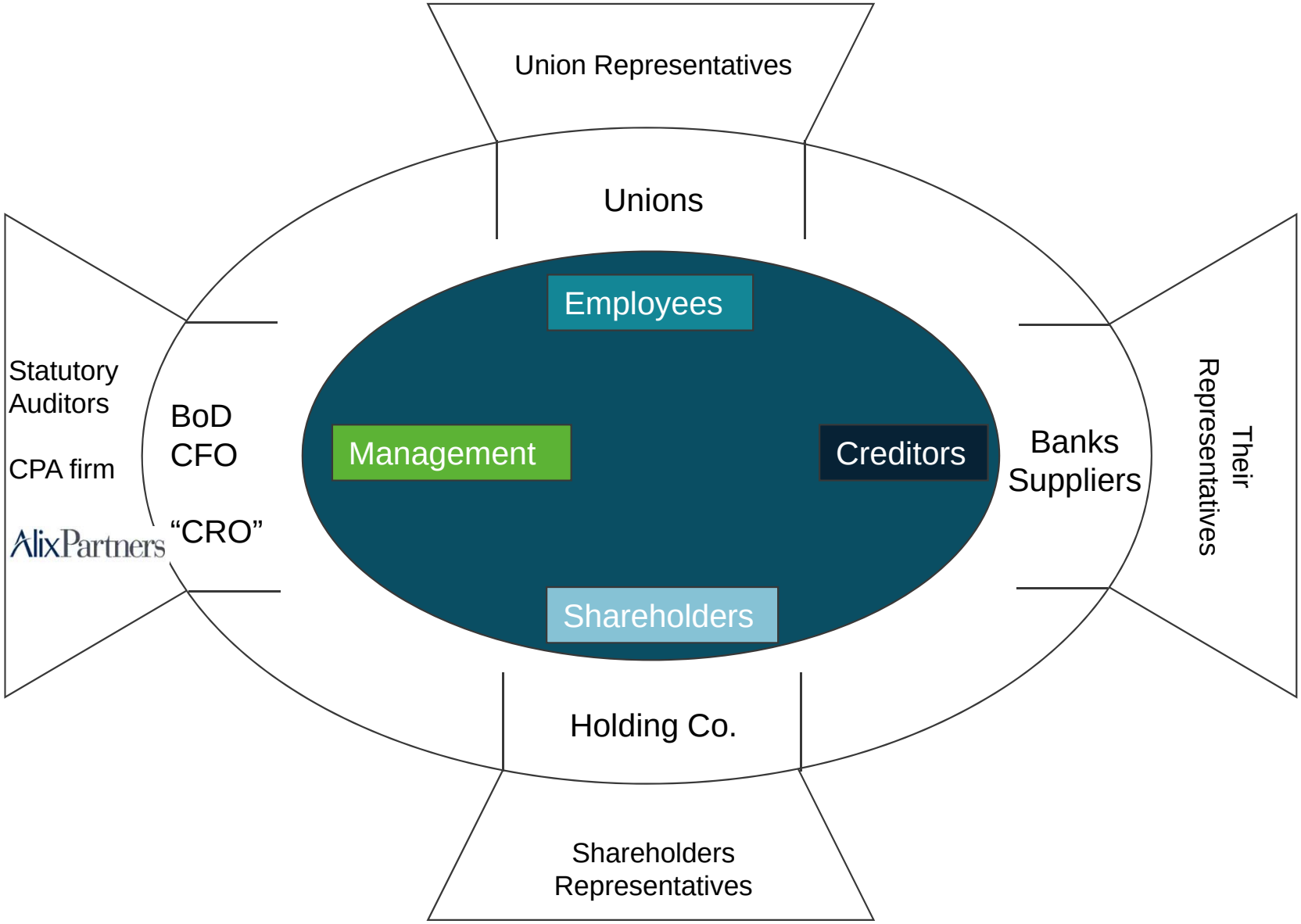
Waste Italia bondholders set to go private again, stances on new money provision still far apart
25 October 2016 | 18:01 CEST

Waste Italia's ad hoc bondholder committee is set to go private again in order to get access to additional information under the restructuring process. The investors expect to become restricted this week, and therefore be able to go through the updated liquidity forecast carried out by Alvarez & Marsal, according to sources familiar with the situation.

The report should enable the stakeholders to fine-tune the amount of the new money the Italian vertically integrated waste collection and storage group needs. But the company/shareholder and creditor camps are still far apart regarding the amount of fresh funds to be injected, the sources said.

Source: Debtwire

When to the financial restructuring is attached a significant industrial reorganization the number of stakeholders increases



The beginning of the process

- If the debt is primarily bank debt it is usually the approaching technical default of some covenant that trigger a call of the Firm to the agent bank to initiate discussions
- If the debt is primarily made up of bond, the Company will seek advise from financial and restructuring advisors which will educate the management on the options available and on the fiduciary duties vis a vis the creditors and on the risk of managing in the zone of insolvency
- If it is decided to attempt an out of court restructuring the firm can either invite the bondholders to form a committee or prepare a restructuring proposal to push forward without any prior discussion
- It is more rare that bondholders will initiate the process because they have no bargaining power unless there is some breach of some provision contained in the indenture. Moreover legal action can only be initiated by the trustee

Executing an out of court restructuring agreement

Bank Loans

- In case of bank debt the execution usually consists of an amendment of the loan agreement
- All loan agreements usually require the consent of 100% of the lenders for amendments that change maturity, interests rate and amortization scheme and principal amount
- Bank loan can also be converted into equity or quasi-equity instruments

Bonds

- Restructuring of bonds can be accomplished with only the bondholder committee participants
- The committee will want all bondholders to share the pain and will solicit the participation of the bondholders outside the committee via a formal exchange or tender offer
- The success of the offer will raise the so called ***holdout problem***

The holdout problem

- Participation to exchange offer is voluntary and some debtholder may opt to not participate because they would be better off, assuming that the exchange is executed anyway
- But if too many decide to hold out, all will be worse off because the exchange will not be successful in resolving its financial distress potentially leading the company to file for insolvency (insolvency can bind holdouts forcing *cram down,* but the recovery will be lower)
- Sometimes holdouts may be involuntary (for example: retail investors, or under certain regulation)
- The problem of holdouts escalates with the complexity of the capital structure

EXAMPLE CO: restructuring no holdouts

ASSETS		LIABILITIES	
Fixed assets	490	Debt	290
		EQUITY	
		Equity	200

Debt face value: 1200
Recovery: 488/1200 (~41%)

Effect of holdouts

ASSETS		LIABILITIES	
Fixed assets	490	New Debt	278
		Old Debt	50
		EQUITY	
		Equity	162

Only 1150 of bonds participate
Recovery for participating: 438/1150 (~38%)
Recovery for holdouts: 100%!!!!

How to mitigate the holdout problem

- **Moral coercion**: the players involved are likely to be the same on other restructuring tables on which they can be retaliated
- **Covenant stripping**: the exchange offer can include a provision according to which the tendering bonds are also voting in favor of authorizing an amendment to the indenture which deletes all covenants
- **Support a *pre-packaged* Ch11**: the exchange offer also contain a solicitation to support a pre-pack Ch11 (discussed later) in case the offer fail to reach a minimum participation
- **High minimum participation requirement:** it means that only a minimum number of holdouts will be tolerated so that if the offer is successful then the distress is likely to have been solved. The firm usually maintain the right to unilaterally waive the requirements (avoid that the offer fails for 89,5% participation vs a 90% required).

Real life: holdout

Debt Restructuring Implementation

Mriya may use an English scheme of arrangement to implement its restructuring plan, as reported. However, the company is also considering other options, the CFO says.

“We are a Cyprus company, so we are probably going to use a Cypriot scheme of arrangement which is very close to the English scheme of arrangement. We will run this even if we get 100% approval, because on the bank side we can get a 100%, but we will never get 100% on the bond side. We will have to run the scheme of arrangement to make sure that we can cram down everybody, even the lost bondholders who don’t know they hold the bond because it has been written off to zero.”

“Our legal council is investigating the possibility of doing it in the U.K. such that it is legally valid in Cyprus. Because we have a number of creditors which may oppose a scheme of arrangement and we don’t want to give them the opportunity to go the a court in Cyprus and challenge the scheme of arrangement because it was approved in the U.K. We are now in the process of getting legal advice on whether we can do it in the U.K. or we have to it absolutely. Or whether we can do it in U.K. and get is rubber stamped in a court in Cyprus. This is unclear today. We could do it in Cyprus where the threshold is 50%.”

Although no lenders have rejected the plan, Mriya will not receive unanimous bank support, Huls explains: “Three of our banks are in bankruptcy proceedings and under liquidation with Ukriane’s Deposit Guarantee Fund. These banks can’t approve because they don’t have capacity and secondly they are legally not allowed, because our restructuring is a 7-8 year process and they are only allowed to accept restructurings which will be closed within the period of their liquidation. All these banks are supposed to be liquidated within two to three years time, so these banks will not sign up.”

Source: Reorg-Research

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In court restructuring

Bankruptcy as an opportunity for the distress investor

- There are two main general considerations about bankruptcy:
  - When a company files for bankruptcy it is hardly a surprise for anyone
  - Usually some or all of the creditors will suffer financial losses in the process
- Because of the above original creditors become willing to sell their claims at a significant discount
- Therefor the distress investor can benefit from identifying early firms that are likely to end up in distress and from understanding the implication of bankruptcy on the value of the claim
- In general a company will choose to use bankruptcy to reorganize for two main reasons
  - Non financial liabilities like pension liabilities, unfavorable contracts or leases that can be source of distress can be managed more easily in bankruptcy
  - Difficulties in obtain cooperation in an out of court restructuring (especially in cases in which too many parties are involved)

- **The goal of this section is to give a high level overview of the process using the Chapter 11 of the US Bankruptcy Code as a general framework which contains all the principal concepts useful for the discussion**

Declaring bankruptcy

- A bankruptcy case begins when a petition is filed with a bankruptcy court
- Usually it is the debtor that file a voluntary petition and only in a few cases creditors have grounds to file an involuntary petition
- When the debtor faces an involuntary petition, it is likely to file its own petition and be granted the control of the procedure
- Chapter 11 allows the existing management to reorganize the debtor as a going concern while in a Chapter 7 a court appointed trustee will supervise the liquidation of the debtor’s assets
- The first consequence of controlling the filing is to decide the jurisdiction of filing (i.e. which court)
- The choice of the jurisdiction is driven by factors like one court being more “debtor friendly” or another being faster

Real life: declaring bankruptcy

Caesars Entertainment Operating Company (CEOC) will file a voluntary Chapter 11 petition in Chicago on Thursday, the company confirmed in an objection to the involuntary proceeding initiated by a handful of its second-lien creditors this week in Wilmington, Delaware.

"The Debtors have tremendous respect for the Delaware bankruptcy court, and did not select an alternative forum lightly," CEOC lawyers wrote this morning. "The Midwest is an important hub of Debtors operations, including seven of the Debtors' 27 owned or operated casinos, more than any other region. Two of those casinos are in the Chicagoland area, each less than 40 miles from the Bankruptcy Court in Chicago. (In contrast, the Debtors have no casinos in Delaware.)"

CEOC filed its objection seeking to head off an emergency motion by the second-lien creditors to block a voluntary filing. Late yesterday, Appaloosa Investment filed a motion urging US Bankruptcy Judge Kevin Gross arguing that any additional bankruptcy case should be stayed to avoid confusion in a fight over the appropriate venue for the company's restructuring. Appaloosa and two other holders of the company's 10% second-priority senior secured notes due in 2018 filed an involuntary case against CEOC on Monday (12 January).

"The Petitioners' filings highlight the true aim of their involuntary bankruptcy petition against CEOC, which has nothing to do with seeking the protection of a bankruptcy court," CEOC's lawyers wrote this morning. "By their own admission, the Petitioners—three hedge fund junior noteholders, one of which acquired its debt only a few months ago—have known for at least a month that CEOC would commence a voluntary bankruptcy between January 15th and January 20th."

"The involuntary petition is baseless, and CEOC will move to dismiss it within the 21-day deadline for a response," the company said. "Bad faith, improper involuntary petitions by holders of approximately $41 million in claims cannot and must not be used as an end-run around the Debtors' rights to commence a voluntary, pre-arranged chapter 11 reorganization with the support of holders of billions of dollars of claims."

Source: Reorg-Research

Timing of filing: strategic goals

- **Control the jurisdiction**: the debtor will usually file before it is in material breach of an agreement and be confronted with an involuntary petition
- **Maximize liquidity:** the debtor will want to save cash to be able to fund operations during the procedure, possibly reducing the need for new financing that during a Ch.11 is very expensive and has priority over all old debts (significantly impacting the recoveries available)
- For that, any payments just before the filing is a waste, especially if done to unsecured. As a consequence the debtor may start delaying payments to suppliers to save cash and even draw down all revolving facilities (if available)
- Moreover, the debtor will file before a material interest or principal payment is due

- **All the consideration above make the timing of filing often quite predictable**

Timing of filing: implications

- The time of filing determines that all the liabilities incurred before are considered **prepetition**, while the ones incurred after are considered **postpetition** and have priority versus most prepetition unsecured claims
- **Automatic stay** prevent creditors from collecting claims without approval of court
- The date of filing also sets look back periods related to the permissibility of certain transfers
- Post filing the management operates the company with a fiduciary duty towards the creditors. This fact is referred to a **debtor in possession**
- Any transaction outside the ordinary course of business requires the court approval
- Usually in addition or substituting the old management, turnaround specialist and a CRO are appointed to support the debtor in possession in the restructuring process
- All of the above are, in some form or another, present in all insolvency laws

The main players

- At the beginning of the Ch. 11 the **official committee of unsecured creditors** (“OCUC” or “UCC”)is created and in large cases with complex capital structure more than one committee are established
- OCUCs have fiduciary duty to represent the interests of all the unsecured creditors
- **Secured creditors are grouped in classes** based on the collateral they have interests on
- **Syndicated bank loans will be represented by the bank agent** in the negotiation process
- Equity holders usually will receive nothing but in case there is potentially some value to be recovered for them, a specific committee may be set up

Real life: Equity Committee

Kodak bankruptcy judge delays ruling on appointment of official equity committee - Court Coverage

Proprietary

Story:

Judge Allan Gropper today declined to rule on a request from Eastman Kodak's common shareholders to form an official equity committee. Judge Gropper heard arguments this morning in the US Bankruptcy Court of the Southern District of New York, but provided no timeline for a decision on the matter.

An ad hoc group of equity holders, led by Greywolf Capital, have maintained that the formation of a court-recognized committee is critical at this juncture of the case, given the number of recovery-impacting decisions that will be made. The shareholders also contend that their interests are not represented by the unsecured creditors committee (UCC) or the Kodak board of directors because the parties have already determined that the debtor is insolvent and equity is out of the money, according to court documents.

A number of parties, including the debtor, the US Trustee and an ad hoc group of second lien holders, have opposed the appointment of an official committee, arguing that the shareholder stance is based on pure speculation and have thus far not established a scenario that would result in any equity distribution.

Moreover, Kodak faces a number of unresolved liabilities that could drown out any potential for payout to the equity. The debtor's response to the contested motion noted that the shareholders pushing for the official group "are interested only in maximizing the price of Kodak stock in the short term" since they acquired their shares near the time of the debtor's filing.

"The equity shareholders want to saddle the estate with costs, even if they are wrong," said UCC counsel Dennis Dunne of Milbank Tweed.

The bankrupt technology provider's USD 400m 7% convertible senior notes due 2013 last traded at 29.5, according to MarketAxess. Its USD 10.625% second lien notes due 2019 are quoted in the 85/86.5 context, said a hedge fund analyst. The shares trade over the counter at less than half-a-cent.

Source: Debtwire

The Plan of Reorganization

Preparation of the Plan

- The plan is a legal document which describes what will happen to the debtor, its assets and its liabilities including equity upon exit from bankruptcy
- The most important section will determine the status of the various claims and how they will be treated
- Upon filing the debtor is granted exclusivity to propose a plan within a specific timeframe which can be extended almost indefinitely (it can take more than a year…)
- At the end of the exclusivity period creditors or others can propose a plan (rarely)

Solicitation of the vote

- To solicit acceptance from creditors a disclosure statement is prepared and approved by the court
- The solicitation process is similar to a proxy vote
- In case there is significant cooperation management and creditors can work together to a plan and have it ready for a vote just after filing (“prenegotiated” ch.11)
- If the creditor vote on the acceptability of the plan before the filing (e.g. when proposed as an alternative in a exchange offer to force holdouts) it is called a “pre-packaged” ch.11

Confirmation by the Court

- If the plan is accepted, the Court will verify that meets certain criteria and confirm it
- Confirmation is the event that instantaneously alters preexisting legal relationship (lending agreements, contracts)

Content of the Plan of Reorganization

- The Plan of Reorganization comprises two main sections:

1. The first section identifies all claimants and groups them in classes for the purpose of voting and priority:
   - Each class must contains claims with similar priority against the debtor
   - Secured claims are put in separate classes based on the collateral they have an interest and their lien priority, for an amount that is the lesser between the claim and the value of the asset (if claim > asset the difference will go with the other unsecured claims)
   - The plan may also decide to recognize the different legal entities or to treat them via a substantive consolidation. This decision may substantially change the expected recoveries
2. The second part of the plan provides for what each class will receive:
   - All claims within a class must receive the same treatment
   - Similar claims can be grouped in different classes to recognize the different desires in terms of recovery (e.g. trade claims and unsecured debt have same priority but the latter may prefer cash while the former may prefer stock)

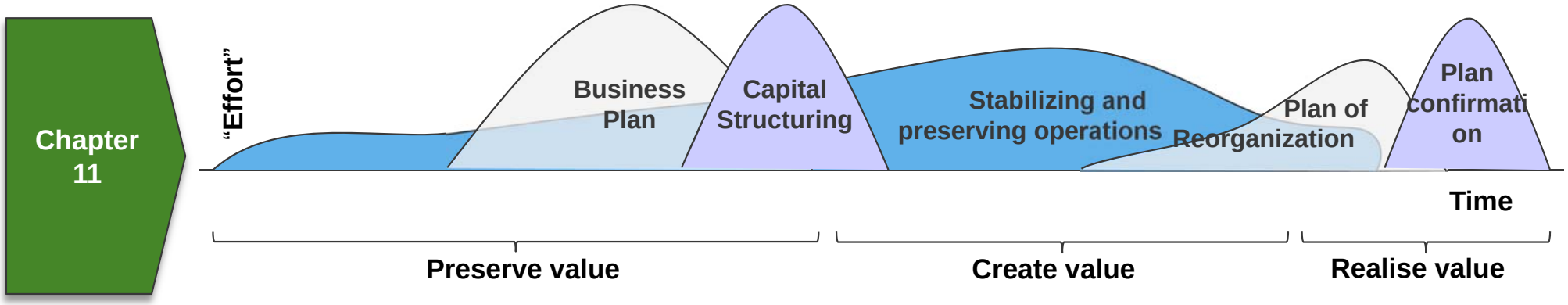
Conceptual example of a Plan of Reorganization

Class	Claim amount	Description	Payout
Administrative Claims*	2M	Post petition cost of lawyers, bankers, advisors	Outstanding claim of 2M will be paid in full upon plan confirmation
Super priority secured claims	8M	DIP financing secured by the company post petition	DIP lender paid in full upon confirmation
Secured claims	1200M	Given EV of 490M and administrative and superpriority claims only 480M are considered secured	Prepetition secured lenders will receive 290M in new notes and 100% of equity. After the payouts the equity value will be 190M
Unsecured claims	200M	Prepetition subordinated lenders	Will receive nothing
Equity			Will receive nothing

- **In the example the Plan of Reorganization replicates the capital structure obtain out of court in slide 5 except for the extra costs associated with the Ch.11**

* Adiministrative claims priority is usually achieved through carve out provisions by lenders to allow such claims to be paid before secured debt (otherwise they will be paripassu)

Impact of filing for Ch.11 on the operations



Impact of filing for Ch.11 on the operations

- Once a bankruptcy process starts **the first objective is to stabilize the operations** of the company and work to **preserve as much going concern value as possible**
- Following the filing the **automatic stay** comes into effect and prevents any creditor from pursuing an action against the debtor without the consent of the court
- In simple terms by avoiding that secured lenders seize chaotically the assets and impair the chances of the company to retain going concern value, the automatic stay mechanism protects value for the unsecured creditors
- Automatic stay also prevent the debtor to have to pay prepetition claims which helps preserving cash to fund operations. The flip of the coin is that suppliers may refuse to extend credit and require cash on delivery.
- In order to be able to fund operations the company, with the approval of the court, may need to enter into a new lending agreement typically referred to as **debtor-in-possession financing** which has priority over prepetition unsecured liabilities if necessary can be grated superpriority
- If priority is not enough to attract DIP lenders, superpriority interest in encumbered can be granted by the court as long as the original secured creditor maintain adequate protection (i.e. the asset has enough value for both the DIP and the original credit)
- To avoid to have to share collateral, sometime secured lenders offer to become DIP lenders

Real life: DIP financing

Eastman Kodak's ad hoc group of 10.625% and 9.75% second lien noteholders plans to argue that the company's USD 950m DIP loan does not provide for adequate protection, said two bondholders familiar with the matter.

The argument is expected to flare up during a 15 February hearing where the debtor is slated to seek full access to the DIP facility.

Impetus for the pending conflict stems from the second lien group's concern that Kodak could run out of cash before the 30 June deadline to set bid procedures for its digital patent portfolio, both sources said.

To protect itself from the downside of a liquidation fallout scenario, the group is plotting to argue that the DIP is over-collateralized, holding super-priority liens on all assets – including PP&E, working capital and intellectual property, the sources continued. The alleged over-collateralization threatens to block the second liens from enforcing claims on certain assets in the event the company either runs out of cash before 30 June, or fails to garner sufficient bids, they added.

A third-party estimate on the value of Kodak's patents filed with the bankruptcy court pegs the entire portfolio at USD 3.4 to USD 4.3bn, including USD 2.2bn to USD 2.6bn for the specific patent pool that's earmarked for auction. While the appraisal is more than enough to cover the USD 1.7bn of DIP and second lien debt, investors are concerned the company will not be able to attract fair market bids, said two hedge fund analysts and a trader.

At issue is who will be the natural buyer for the assets due to potential litigation tie-ups, said the sources close and the analysts. For instance, Eastman Kodak and Apple have been waging war in courts for months over allegations of patent infringement. For its part, Apple has filed a motion contending that the disputed patents are not part of the collateral pool under the DIP facility

Another concern is that Kodak's auction process is going to be rushed since pre-petition attempts to engage potential bidders on 1,100 patents were halted by financial advisor Lazard in November on fears that investors could construct fraudulent conveyance arguments if bids came in cheap, added a private equity source, an advisory source and a flow desk analyst. As a consequence, the debtor did not have a running start on the sale process when it sought Chapter 11 protection in January. Had the sale process continued through 4Q11, the company may have have a stalking horse bidder by now, setting the bar for future bids, said the advisory source and the desk analyst.

Meanwhile, the second lien group's financial advisor Blackstone is conducting due diligence on how constituents can backstop an alternative DIP proposal, said the first bondholder, a third bondholder and the desk analyst. But given that a handful of large second lien bondholders participated in the syndication of the Citigroup-led DIP, pointing out flaws in the current structure could be a stretch, two of the sources continued.

Source: Debtwire

Developing a going forward business plan

- After the day to day operations are stabilized, the next goal is to prepare a new business plan for the firm
- This process is largely in control of the management and its advisors but the debtor will likely consult with the OUCC during the development of the business plan
- The area of likely challenge and discussion will be if the firm should stay as a stand alone entity after reorganization or a sale of parts or the entire perimeter of its business is the best way to maximize value for the creditors

Determining assets and liabilities

- While the business plan is being developed, the debtor and its creditors will work to determine the composition of the estate's assets and liabilities
- The assets and liabilities as described in the Plan of Reorganization may significantly differ from the GAAP balance sheet at the time of filing

ITEMS IMPACTING ASSETS

- Certain payments or transaction (**voidable preferences**) that occurred before the filing (90 days*) should be unwound and the assets brought back
- Unwound of transaction in which the debtor did not receive fair value in the transaction and at the time or as consequence of it the debtor was insolvent (**fraudulent conveyance**)
- **Lawsuits** that the debtor or the OUCC can bring (e.g. to director, auditors, affiliated parties etc.)

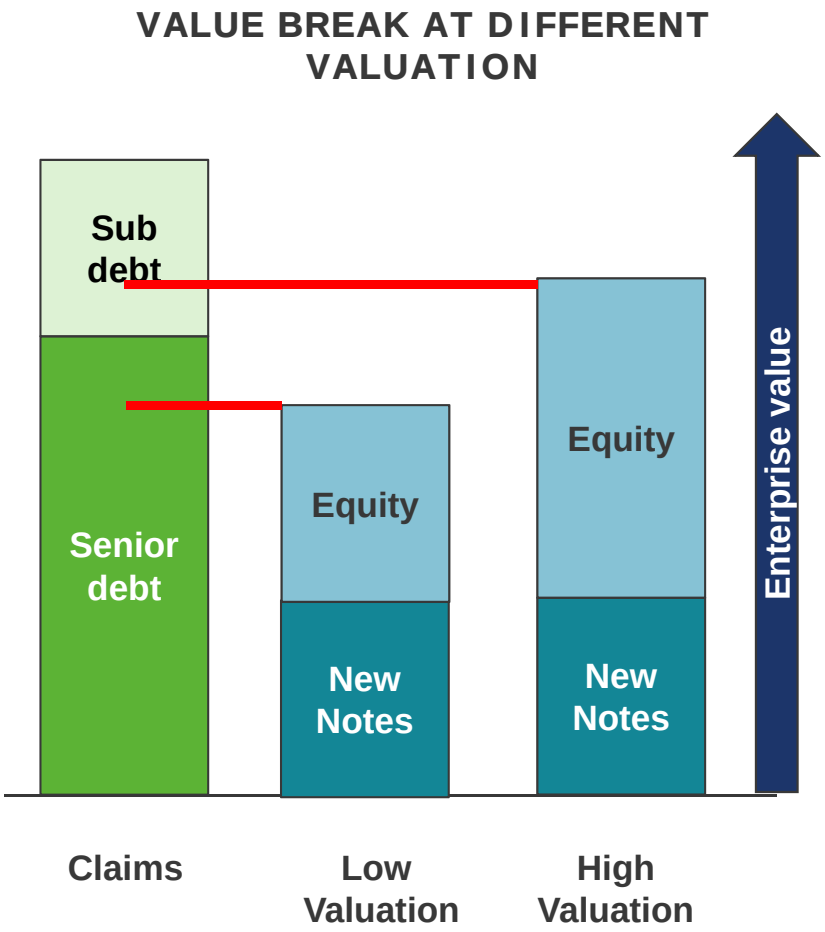
ITEMS IMPACTING LIABILITIES

- Bankruptcy allow the debtor to reject **unfavorable contracts**** or unexpired leases with the consequent damage claims considered as prepetition unsecured claims
- In bankruptcy the court has the power to consolidate **tort claims,** expedite the valuation of the compensatory liability and establish a trust for future claims

* One year if with insiders

**Rejection must be approved by the court and certain contracts such as collective bargaining agreements and retirement benefits will be subject to higher rejection standards

Valuation and the new capital structure



Absolute Priority Rule: *Priority claims must be paid in full before lower claim can be considered*

- As part of the Plan of Reorganization, two valuation must be prepared: a liquidation valuation and a going concern valuation
- The liquidation valuation is less important and is needed to prove that creditors will not receive less in a reorganization that they would have received in a liquidation (best interest of creditor)
- The going concern valuation is usually prepared by the debtor financial advisor and will be the object of intense debate and disputes
- From the valuation depends if a certain class of claim will get any recover based on the absolute priority rule
- The valuation and the allocation of the capital structure are essentially negotiated and unsatisfied creditors can challenge the valuation and propose an alternative valuation which, if accepted, would make the treatment of claims inappropriate

Voting the approval of the Plan of Reorganization

- Court must approve disclosure statement before it can be sent to creditors except in pre-packs
- Approval can be easy process if parties generally agree or highly contentious
- Imagine the low valuation was proposed; sub lenders would argue it is misleading because it is materially inaccurate
- Court's scope of review is limited at this point to whether the disclosure is sufficient to enable creditors to make an informed vote
- Once package is approved by court, it is sent to the claims holders:
  - Unimpaired holders are assumed to accept and are not solicited
  - Claims holders receiving no recovery are assumed to reject
  - Impaired classes that are receiving some recovery are the ones that actually vote.
- For a class to accept the plan, more than 50% in number of claims representing more than 66.6% in amount must vote in favor
- A certain degree of freedom to group claims in classes is available and the court will control that the process does not become subject to manipulation through gerrymandering

Confirmation of the Plan of Reorganization

- Once votes are tallied, confirmation hearing is set. In addition to procedural requirements, there are 4 tests that represent minimum standards of fairness that must be met
  - **Best interests of creditor test**: The recoveries under plan are greater than recoveries under Chapter 7 liquidation
  - **Good faith test**: Requires that Plan of Reorganization be proposed in good faith. This is vague and rarely is a successful way for opponents to block Plan of Reorganization ("POR")
  - **Feasibility test**: The POR should ensure that company will not likely result in further restructuring or subsequent liquidation. Any creditor can raise objections to POR under these grounds and it is in fact a contentious part of the claims hearing. For example, opponents in a high valuation scenario may argue that the postpetition company is overleveraged
  - **Consent or cram-down**: Even if an impaired class votes to reject the plan, the proponent may ask the court to adopt the plan despite the objection (cram-down). A cram down can occur as long as the POR be approved by the majority of the classes and at least one impaired class, the court finds that the plan is "fair and equitable" and does not unfairly discriminate against objecting class
- A consequence of the cram down is that all impaired classes need to vote favorably, in order for the debtor to be able to provide some recovery to a class out of the money without having paid in full more senior classes as would be required by the absolute priority rule

Real life: highly disputed confirmation

Quiksilver Inc. obtained court confirmation of its reorganization plan this afternoon, just an hour after filing an amended plan on the docket that resolved objections from the official committee of unsecured creditors (UCC).

Judge Brendan Shannon said he would confirm the plan during a hearing held today in the US Bankruptcy Court for the District of Delaware. Under the amended plan, sponsor Oaktree Capital Management agreed to boost distributions to unsecured creditors in both cash and equity in the reorganized company, heading off what was shaping up to be a contentious, multi-day confirmation trial. Debtor counsel Van Durrer of Skadden Arps joked at today's hearing that the parties "have put down our shovels, rakes and other implements of destruction."

The settlement follows a mediation process overseen by Judge Robert Drain earlier this month over a valuation dispute between Oaktree and the UCC. Leading up to confirmation, the two sides argued over the debtor's total enterprise value, with the committee putting the figure at USD 690m and the debtor at USD 546m. With a higher enterprise value, the UCC argued, there should be a more significant recovery for unsecured creditors.

The final plan will convert USD 280m in secured debt, 70% of which is held by Oaktree Capital management, into equity in the reorganized company. Oaktree is backstopping a USD 122.5m rights offering and has already provided USD 175m in debtor-in-possession financing.

The plan initially proposed that unsecured creditors would split a USD 7.5m cash pool, but later raised that figure to USD 12.5m. Today's amended plan increases the cash payout to USD 14m, and gives unsecured creditors between 3.56% and 4.75% of the reorganized company's equity, depending on whether the company completes an exchange of its euro notes.

Quiksilver will support its exit with a USD 140m asset-based revolving exit facility and a new USD 50m delayed-draw term loan facility.

Quiksilver, a sportswear retailer, entered Chapter 11 in September with a plan support agreement to convert its senior secured notes into equity.

3

Cross-borders issues

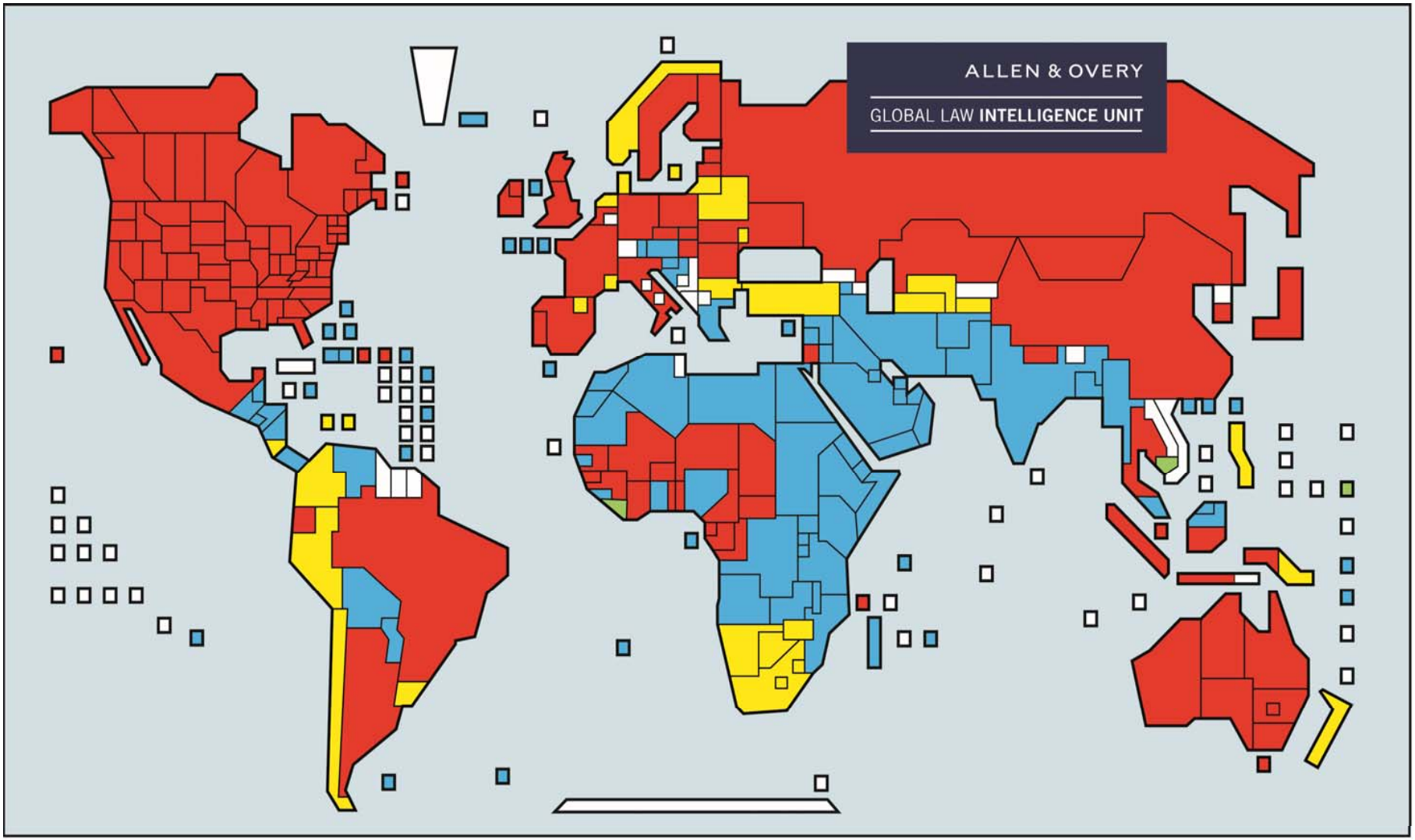
Issues in a cross border restructuring

- No law recognises the concept of a “group of companies”, although laws differentiate between large and small companies
- A group of companies is a commercial construct organised for the benefit of the shareholders of the parent company, often to the detriment of individual entities, particularly as costs are rarely fully allocated
- Problems result from a lack of understanding of jurisdictional differences
- In a cross border restructuring, historic relationships between holding companies, subsidiaries and their management teams often change:
  - The legal entity structure becomes very important
  - Who generates cash, who consumes it and how cash flows around a group becomes critical
  - Junior management in foreign jurisdictions can suddenly become important and question the requests of senior executives
  - The quality and approach of lawyers and advisors to previously unimportant subsidiaries can become essential to a successful restructuring
  - Tax structures set up in good times can cause significant problems in the zone of insolvency
  - Suspicion and mistrust can paralyse organisations without regular, open communication
- Restructurings become more complex, time-consuming and expensive
- Successful outcomes require patience, persistence and an ability to listen

Insolvency laws differ across countries

- Key differences tend to be:
  - **Trigger**
  - Types of process
  - **Look back period for preferences, unwinding of transactions**
  - **Ability of claims to pierce the corporate veil**
  - Equitable subordination
  - **Subordination of intercompany claims**
- European insolvency regulations:
  - COMI
  - Secondary proceedings

Corporate insolvency rescue statutes are today available in most countries



...however traditional partitions in jurisdiction still contribute to the complexity of cross border cases

Insolvency proceedings snapshot comparison – Key European legislations

	Italy	France	Germany	England
Key concepts	Court reviewed restructuring agreements; Concordato Preventivo (scheme of arrangement) Administration (eligibility criteria) ; Bankruptcy	Compulsory/voluntary liquidation Mediation, safeguard proceedings, reorganisation, conciliation	Liquidation Out-of-court liquidation Insolvency plan, self-management, out-of-court composition	Compulsory liquidation CVL Administration, schemes of arrangement, CVA
Time limit for filing	Cashflow and balance sheet test, no explicit time limit but criminal and civil responsibility assessed ex post	Within **45 days** of the company being unable to pay its maturing debt	**Immediately** upon being unable to pay maturing debt or upon over indebtedness occurring	No express time limit – failure can however trigger legal proceedings
Maximum claw-back	1 year (subject to knowledge of insolvency or unusual payment methods)	1.5 years	10 years	2 years
Ranking of claims	+ Most employee claims + Certain taxes and professional fees + New money if Court authorized - Shareholder loans	+ Employees + Certain legal fees + New monies - Certain loans/bonds	+ Certain employee compensation claims - Shareholder loans	+ Salaries and pensions - Post-liquidation interest

Insolvency proceedings snapshot comparison – Key European legislations

	Italy	France	Germany	England
Management	***Winding down:*** **Trustee** ***Reorganisation:*** **Commissioner**	***Winding down:*** **Liquidator** ***Reorganisation:*** **DIP (under supervision)**	***Winding down:*** **Administrator** ***Reorganisation:*** **Management**	***Winding down:*** **Liquidator** ***Reorganisation:*** **Depends**
Cram down of creditors	• In case of Concordato Preventivo requires approval of simple majority of classes of creditors	• Requires 2/3 of the debt outstanding	• Requires majority in number and in value for each class of debt	• Requires majority in number, ¾ in value
Automatic stay	All executions are suspended	In safeguard, rehabilitation and liquidation only	During preliminary proceedings	Exceptions exist for secured creditors
Personal liability of directors	• For breach of duty and failure to preserve the company's value if that failure results in a loss to creditors • **Criminal liability** in certain situations	• Management faults contributed to insufficiency of assets company's insolvency • **Criminal liability** in certain situations • Disqualification up to 15 years for personal and criminal bankruptcy	• Failure to file for insolvency • Payments made to third parties after the company becomes insolvent • Any new commitments which the company is unable to fulfil	• Breach of duty • Wrongful trading • Fraudulent trading • If convicted, disqualification period may total between 2 and 15 years

European Insolvency Regulation – The Center of Main Interests (COMI)

- **COMI ("Center of Main Interest")** definition in the Regulation:
  - **"The centre of main interests should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties**" (Paragraph 13 of the preamble to the regulation)
  - "In the case of a company or legal person, the place of the registered office shall be presumed to be the centre of its main interests in the absence of any proof to the contrary" (Article 3(1) of the regulation)

  → not well defined and allowing many different interpretations

  → opened room for "forum shopping" – while intention of regulation was to avoid this

- Different ways for interpretation:
  - **COMI as the "brain" of the company**, i.e. location where the "life and death decisions for the company are taken" (often holding company)
  - **COMI as the "heart" of the company** (e.g., key production plants, product related value adding activities, majority of employees, etc.)

  →over the last years **shift from "brain" to "heart" interpretation**

  →shift of COMI more difficult (COMI shift for holding company was easier)