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FORUM

Key trends in corporate restructuring and insolvency

FW moderates a discussion on key trends in corporate restructuring and insolvency between Partha Kar at Kirkland & Ellis International LLP, Kenneth M. Krys at KRyS Global, Melanie L. Cyganowski at Otterbourg, Steindler, Houston & Rosen, P.C, and Van Durrer at Skadden, Arps, Slate, Meagher & Flom LLP.

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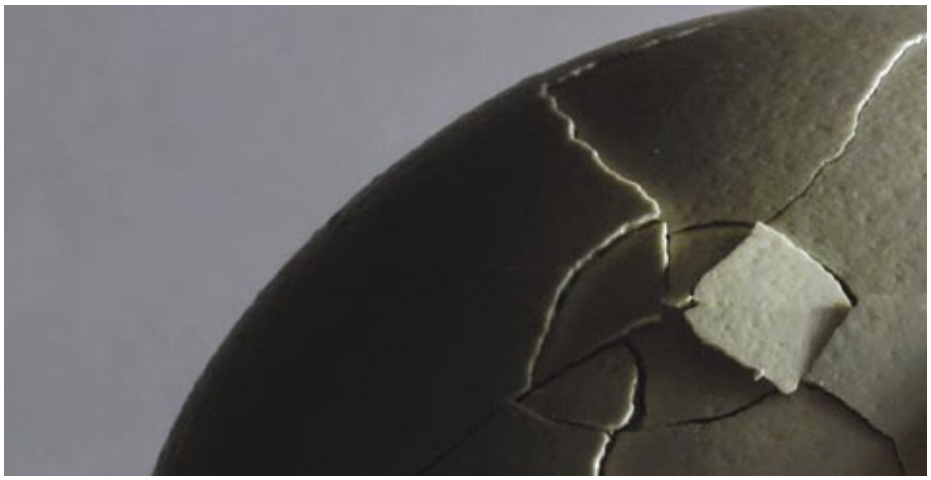


FW: Broadly speaking, how would you describe the restructuring and insolvency market over the last 12-18 months? What impact are economic and financial forces having on companies in general, and how are they coping?

Krys: We have seen a decrease in formal restructuring and insolvency appointments over the past 12 to 18 months when compared to the previous period as the impacts of the financial crisis settle. In the Cayman Islands we are not currently seeing significant numbers of companies being put into an insolvency process by banks or financial institutions. This indicates that local banks are working with borrowers to assist restructuring and address debt issues. Following the fallout from the 2008 financial crisis and a period of inactivity in certain investments, investors are starting to review these situations due to liquidity issues, to see what steps can be taken to turn those investments into cash. However, a precautionary sentiment continues to linger with investors conscious of issues in large financial markets such as Europe.

Cyganowski: Throughout 2010 and the first half of 2011, the restructuring and insolvency markets have been relatively quiet, especially when contrasted against the firestorm of activity that occurred several years prior. Recently, however, the volume of restructuring and insolvency cases has steadily increased, with a number of large or high profile companies filing for Chapter 11, including American Airlines, commodity brokerage firm MF Global, and paper maker New Page Corp. Starting around the tail end of 2009, many lenders and their financially distressed borrowers, especially in the middle market, negotiated to delay debt maturities with the hope that the economy would rebound and business would pick up before the extended maturity dates. However, with the economy still in flux and these extended maturity dates nearing expiration, many companies will soon be facing a liquidity crisis.

Kar: It is fair to say that the restructuring and insolvency market has generally been quieter than expected for the last 12 to 18 months although there has been a substantial pick up in enquiries and contingency planning work since the summer, a result primarily of the effective seizure of bank lending and the general downturn in economic conditions. The European financial crisis has not been out of the news for several months and is having a clear impact on companies in general, their customers, their suppliers, and their lenders. There also appears to be issues in other parts of the world which are likely to contribute to the negative sentiment, and have a negative impact on market conditions. Many businesses are finding it a challenge in the current environment.

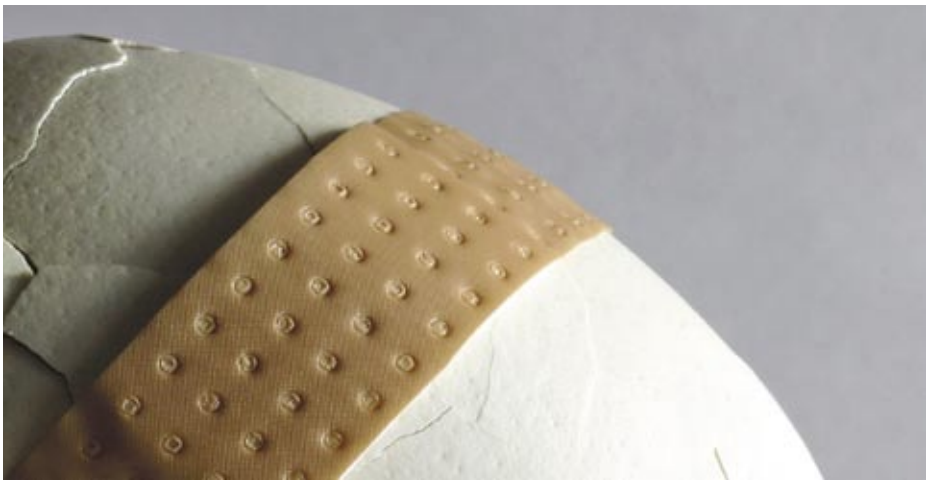
Durrer: The number of companies entering default scenarios or otherwise in need of a financial restructuring has definitely increased in the past 12 months, and we see that trend continuing into 2012. There are several forces behind this activity. First, the general softness of the economic recovery continues to create revenue pressure for many companies. Second, the volatility of the capital markets makes it very challenging for companies to resolve issues in their capital structures absent going into default. Third, that same volatility continues to create obstacles to companies that are developing go-forward business plans and strategies because there is so little visibility for long term planning. That said, we are seeing distress players invest more money in sound companies that have balance sheet issues. In other words, we are seeing more restructurings successfully completed.

FW: Have any high profile insolvencies or bankruptcy-related court decisions captured your attention in recent months?

Cyganowski: In July 2011, the United States Supreme Court issued its well publicised and highly controversial decision of *Stern v Marshall,* 131 S. Ct. 2594 (2011). In *Stern v Marshall,* the Supreme Court ruled, in a five-four split decision, that US bankruptcy courts lack the constitutional authority to enter final judgment on a state law counterclaim that does not need to be resolved as part of the bankruptcy process. The ruling raised fundamental questions concerning bankruptcy judges' authority to determine a wide variety of issues that, prior to the decision, bankruptcy courts routinely determined as a matter of course. Although the decision is only a few months old, it has already been cited in more than 100 bankruptcy court cases, with bankruptcy judges questioning their ability to issue final judgment in cases ranging from requests for relief from the automatic stay to fraudulent transfer proceedings. While many bankruptcy courts have interpreted the decision narrowly – meaning they interpreted the decision as inapplicable to the matter before them, bankruptcy courts, as well as debtors and creditors involved in bankruptcy related litigation, will likely continue to struggle with the implications of the decision until the appellate courts provide the necessary clarity.

Kar: The decision of the English High Court in *Rodenstock GmbH* [2011] EWHC 1104 makes it clear that an English scheme of arrangement is now a legitimate tool that is available for European restructuring involving English law credit agreements. This case confirms that a company does not need to shift its COMI to England or even have an English establishment where an English scheme is proposed, provided there is sufficient connection established using the English law governed credit agreements. Also, the European Directories case – *HHY Luxembourg S.a.r.l. v Barclays Bank Plc & Ors* [2010] EWCA Civ 1248 – was also an interesting decision where the Court of Appeal followed the Supreme Court's approach in other cases that a commercial interpretation of clauses should be considered in the context of the agreement as a whole; relevant, in that case, when looking at the release clause in an intercreditor agreement.

Durrer: Judge Walrath's recent rulings in the *Washington Mutual* case are beginning to generate repercussions in restructuring negotiations. Briefly, in that case the court ruled that the status of settlement negotiations among key parties to a restructuring, including, potentially, the term sheets transmitted between such parties, could be material non-public information required to be disclosed to the market following the expiration of a confidentiality agreement among the parties. Already, we are seeing the law of unintended consequences play out, in that the decision has somewhat ▸▸



chilled restructuring negotiations or at least slowed the parties' communications in certain instances.

Krys: The filing for Chapter 11 protection of MF Global in October 2011 triggered the largest corporate collapse in the US since Lehman Brothers in 2008, and is the eighth-largest filing of its kind in the US. MF Global used a large number of complex and controversial repurchase agreements for funding and for leveraging profits, and includes trades concerning some of Europe's most indebted nations. The bankruptcy of MF Global is just one example and raises the question of whether more situations like this may exist globally in offshore jurisdictions and in other countries trading sovereign debts. It is not possible to know how many of these funds operate sincerely. More broadly speaking the negative impact from similar fund failures, and from the current issues in Europe, is very likely to be seen in financial markets globally and the offshore jurisdictions.

FW: Are you continuing to see a preference for out-of-court restructuring solutions, including pre-packaged and pre-negotiated bankruptcies?

Kar: Out of court restructuring solutions have always been the preferred way forward in Europe save that court processes may be used to implement agreed proposals that obtain a high majority of consent, but not 100 percent consent. Such implementation methods may include English administrations and prepacks, English schemes of arrangement, local share pledge enforcements, and so on. Many European jurisdictions are moving to a rescue culture and are enacting real restructuring – rather than insolvency – laws, but we are yet to see whether this results in more court filings for restructurings. I think this is fairly unlikely until a substantial precedent base is built up around those procedures. Few people want to be the first to test these new laws, but the fact that they have been passed is great progress in itself.

Durrer: For a company that needs to correct its balance sheet, as opposed to a more in-depth operational restructuring, pre-packaged bankruptcies are ideal. The company spends less, or almost no time, in a formal proceeding which is not only cheaper for the company in terms of transaction costs, but is also more efficient in terms of potential loss of value through the process. More specifically, loss of value in a formal in-court proceeding can take many forms. First, competitors can try to take advantage of a company's distress – much more detailed information regarding the company in a proceeding becomes public, for one thing. Second, customers and other critical partners can become nervous regarding the uncertainty of an in-court process. Finally, employees are often distracted and concerned about a prolonged in-court process and they may lose focus on the task of running the company. The good news is that courts continue to embrace the notion of a pre-negotiated case, so even if there is time that must be spent in court, it can be as minimal as possible in such situations.

Krys: We have seen a trend whereby investors or creditors are fatigued and have less appetite for pursuing recoveries through litigation which can often take a number of years before there are recoveries through settlements or successful litigation of the claim and enforcement of any judgment. Investors and creditors are often willing to forgo potential future recoveries and will consider alternatives such as schemes of arrangement as a potential avenue to bring about a more timely resolution and distribution.

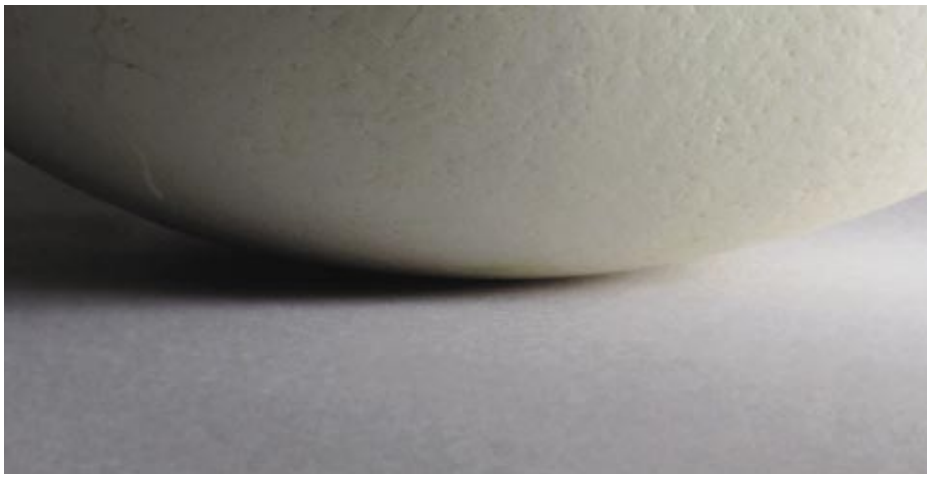
Cyganowski: Due in large part to the additional administrative and professional fees associated with Chapter 11, we see distressed companies continuing to seek restructuring solutions out of court rather than through Chapter 11. For example, more companies are amending and extending their existing credit arrangements through either a forbearance or amendment agreement with an eye toward achieving a liquidity event or executing a turnaround business plan. Another out of court option is when the secured lender conducts a 'friendly foreclosure' sale of its collateral under Article 9 of the Uniform Commercial Code. Of course, in situations where Chapter 11 might be necessary to a restructuring, for instance where a distressed company wishes to jettison economically unfavourable contracts, pre-packaged and pre-arranged are the favoured remedy.

FW: Are distressed debtors finding it any easier to raise capital to fund restructuring plans? What financial solutions are they utilising to resurrect their business?

Durrer: Interestingly, some companies are having some success in refinancing debt. Suspect industries, however, are having serious challenges. For instance, commercial real estate continues to face considerable challenges. Real estate companies are facing large maturities in the coming months and years, and there is little money for refinancing in the markets for such companies. We should expect to continue to see foreclosures and bankruptcies resulting from these scenarios.

Krys: Typical sources of capital such as banks or private investment have almost disappeared. One of the things we have seen in the past year or two is an increase in the number of investment management firms and larger financial intuitions setting up distressed debt departments with the purpose of finding distressed situations in which they can invest. Such parties typically have significant liquidity and a high risk appetite, however they are also expecting big returns for that risk, sometimes taking up to 50 percent of future returns, and they will likely also want control over the process and any turnaround plan.

Cyganowski: Relative to 2009 and 2010, the financial markets have been more robust throughout 2011. However, lenders – having absorbed their fair share of losses over the past few years – are increasingly selective when it comes to determining which companies to finance. The more financially sound companies are able to attract fresh capital, often with lenders competing to participate in the financing. By contrast, financially distressed companies are struggling to obtain financing and, therefore, are often left trying to negotiate an 'amend and extend' with their existing lenders. Of course, companies with various ▸▸



layers of secured debt have a more difficult restructuring task because the maturity dates and other key restructuring terms usually must be reached for all tranches of debt.

Kar: In terms of debtors, it is difficult to raise capital given the issues in the Eurozone at present, however we have seen a number of restructurings where lenders are asked to put new money in particular in distressed situations. A recent example is Thomas Cook. It is interesting to note that many investors, despite the current environment, have in fact raised substantial new funds for distressed investing which means that, in general terms, there is capital in the market but this capital is not necessarily being deployed in the current round of restructuring transactions. Some of the restructuring deals being currently undertaken probably leave too much debt on the company or may be seen as 'extend and pretend' and in those circumstances it is difficult for investors to use their new money capital. Of course, we have seen circumstances where new money has been provided to deal with liquidity issues and capex needs, so it is difficult to generalise on this. In relation to resurrecting businesses, we have seen management teams and investors working together to formulate new business plans, looking to make investments, acquisitions, and so on, to improve businesses – but new investment is not always necessarily the answer. This remains a challenge in the current economic climate when there is much uncertainty and it is difficult to forecast with accuracy, particularly in the long term.

FW: Is it more likely in the current climate that a struggling company will be sold instead of passing through a traditional restructuring process and emerging intact on the other side?

Krys: In the current climate, there are few parties available to purchase struggling companies, and quite apart from the financial reasons, these struggling companies tend to have other problems such as fund governance or some element of fraud which have resulted in the funds being diverted to the detriment of the company. In such cases, where there is fraud, liquidation is usually the most appropriate course of action. In the current market, there are fewer options, such that restructuring and working with creditors and lenders is often the only avenue.

Cyganowski: The assets of a struggling company are today more likely to be sold, whether out of court or through a sale under Section 363 of the Bankruptcy Code than as part of a traditional reorganisation under Chapter 11. In fact, many 'amend and extend' arrangements require, as a condition to the extension, that the company agree to a sale process. Even companies that enter Chapter 11 hoping to reorganise often wind up selling instead. For example, mobile communications company TerreStar Networks and home video retail chain Blockbuster Video both wound up selling under Section 363 after initially filing for Chapter 11 with the intent to reorganise.

Kar: It is difficult to generally say whether a company would be sold rather than restructured – this needs to be looked at on a case by case basis. There are obviously benefits in selling a company but the down side is that the price expectations of the existing stakeholders may not be met, this means they may have to take a write down or a loss which, in the current environment, would be unacceptable. This is the very reason that 'extend and pretend' restructurings exist and, at the moment, it is unlikely that this is going to change in the short term when the lender community itself is under so much stress.

Durrer: Shorter, faster bankruptcies are becoming the 'new normal' or, in other words, more traditional in the current climate. To the extent that "a traditional restructuring process" refers to a distressed company that is in need of operational fixes – such as replacement of key managers, restructuring of labour and vendor costs, relocation of key facilities, compromise of legacy liabilities, and renegotiation of key contracts – those are indeed rarer these days. For one thing, it takes a very robust company to survive the process of an operational turnaround. It takes a great deal of liquidity and patience to accomplish that. In addition, the in-court operational turnaround faces many challenges, not the least of which are the transaction costs and the fact that in the US, the Bankruptcy Code is less conducive to such activities due to amendments by Congress in 2005.

FW: In your experience, what are some of the challenges that frequently arise in corporate liquidations?

Cyganowski: In my experience, one of the biggest challenges in corporate liquidations is that they increasingly involve litigation or threats of litigation. Having lived through the wave of liquidations and insolvencies that hit in 2008 and 2009, creditors are now more sophisticated and have a better understanding of the process. Further, with many liquidating companies leveraged to the hilt, unsecured creditors, who might otherwise receive little or no recovery in the liquidation, are increasingly threatening, or actually pursuing, fraudulent transfer and other lender liability claims as a means to enhance their recovery – most often through a settlement with the secured lenders.

Kar: Finding new money on acceptable terms, ensuring the continuity of the business, and trying to find a buyer for any viable part of the business as quickly as possible, are key challenges. The reality is that, in the current environment, businesses that go into liquidation very rarely come out, or come out whole. Formal processes in Europe are often best avoided if the goal is to quickly preserve the going concern.

Durrer: One challenge that we often see in corporate liquidations is a struggle for control over the process. In liquidations, where there are certainly insufficient assets to satisfy all constituents, it is unfortunate that the dwindling assets must be allocated first to fund battles over who will control the process. For example, there may be a bankruptcy trustee or other fiduciary attempting to conduct an orderly wind-down, while a creditor or group of creditors are seeking to unseat the fiduciary and replace her with one of its own choosing. A more cooperative, negotiated approach will often yield a greater recovery to all.

Krys: Investors have become increasingly cautious and risk averse when it comes to considering the options available to them. They often have less of an appetite for pursuing recoveries through lengthy litigation and are keener to chase low hanging fruit than longer term strategies through litigation. Often the entity will have very little in regard to cash or assets and legal remedies can be complex and involve significant cost with a number of stages and rulings involved. Courts have set a higher bar for disclosure with liquidation committees and liquidators must maintain a relationship of transparency with the liquidation committee and ensure they are involved in the process. Cross-border cases pose further challenges such as obtaining recognition of your offshore proceeding in other jurisdictions.

FW: In terms of bankruptcy litigation, can you highlight some of the common disputes impacting the restructuring and bankruptcy process in today's market?

Kar: The *European Directories* case is an example of common issues we are seeing in the current cycle of restructurings in Europe – documents with apparent errors or defects that may lead to parties being given apparent 'hold up rights' or not having rights they would otherwise expect, thus changing the expected balance of power between the stakeholders. Although very few of these cases have gone to a hearing, documentary and interpretation issues like this are very common and my expectation is that we will see more of these cases, notwithstanding that *European Directories* has given guidance on how these clauses should be interpreted. I also expect there will be some form of a large scale challenge against the use of English processes for European companies or groups, although this may take some time if it is to be seen through to the European Court of Justice.

Durrer: There are two disputes that continue to arise with the most regularity. First, we still see many valuation disputes, where the senior constituent in the capital stack has a pessimistic view of value, believing most of the value of the company belongs to it, and where the less senior constituents have a more optimistic view of value, believing that more of the value of the company belongs to them. Sometimes there is a perverse incentive for junior constituents to use the threat of a valuation dispute to delay the process of a restructuring for so-called 'hold-up' value. Other times, however, the difference of opinion is entirely genuine and derives from different assumptions about future performance or direction that impact value. The other area where we still see quite a bit of litigation is where parties seek to reverse or avoid past transactions. In other words, the company cannot determine what parties are entitled to participate in the value of the company until these transactions are properly sorted. Again, this can be an expensive and time-consuming process. When it is clear that past transactions will become an issue, some companies have been successful in conducting their own independently-led investigations of such transactions in order to avoid the greater expense and delay of litigation.

Krys: Recently, the Supreme Court ruled in the matter of *Stern v Marshal,* on the bankruptcy court's jurisdiction to enter final judgment in respect of certain state law matters. This has a number of possible implications to past, present, and future bankruptcy litigation. It is likely any litigation will involve more time fighting 'turf wars' about whether a particular action belongs in bankruptcy court or somewhere else and further arguments about the finality of past and future rulings of the bankruptcy court in light of the jurisdictional issues. A further practical effect will be a possible delay to proceedings with cases moving away from more efficient bankruptcy courts. UNCITRAL Model Law is still developing and INSOL is constantly revisiting whether any revisions or adjustments are necessary. Certainly, the number of countries that have not adopted the UNCITRAL model law, which would assist in the ability of a foreign liquidator to have foreign proceedings recognised in those jurisdictions, still continues to be a problem.

Cyganowski: With Chapter 11 continually used as vehicle to effectuate a sale of the assets of a distressed company pursuant to Section 363 of the Bankruptcy Code, many of the common disputes today arise in that context. For example, as 363 sales often leave the Chapter 11 debtor with little or no assets to pay the operating expenses it has incurred during the Chapter 11, including expenses incurred in furtherance of the 363 sale, bankruptcy judges will usually require a 'carve out' from the sale proceeds to pay these expenses. In this regard, disputes often arise with respect to the amount of the carve out and how it will be funded – usually by either the secured lender directly, or through an allocation of the sale proceeds for these expenses. Another dispute that often arises in the context of the 363 sales relates to which, if any, liabilities the buyer will assume as part of the sale. Labour unions often put pressure on the buyer, both in bankruptcy court and through the media, to hire the employees of the Chapter 11 debtor and to assume the Chapter 11 debtor's pension liabilities. ■

OPINIONS ARTICLES

Fallout from Madoff scandal hits banks in Fairfield Sentry litigation

BY MARK S. INDELICATO, RONALD R. SUSSMAN AND NICHOLAS SMITHBERG

A perfect storm, formed in the Caribbean, is roaring into the United States, Europe and Asia. Not in the skies, but in the courts.

In the aftermath of the well-publicised scandal stemming from the Bernard Madoff Ponzi scheme, collateral litigation has proliferated in the US and abroad. One such lawsuit, the multi-party litigation in *In re Fairfield Sentry Ltd.,* has created a legal black hole, drawing dozens of financial institutions in Europe, Asia, the Caribbean and elsewhere into high-stakes litigation with billions of dollars at stake.

Before we delve into the dizzying array of substantive and procedural issues implicated by these cases, we should first meet our cast of characters.

As is now well known, Bernard L. Madoff operated an investment fund, Bernard L. Madoff Securities, Inc. ('Madoff Securities'). Fairfield Sentry Ltd. (together with an affiliated fund, 'Fairfield') was the single largest investor in Madoff Securities. Fairfield, chartered in the British Virgin Islands, acted as a 'feeder fund' for Madoff Securities, funnelling billions of dollars in offshore investments into the enterprise. Fairfield styled itself as an 'International Investment Company', offering its shares exclusively to investors outside of the United States. In reality, Fairfield was nothing more than a channel to Madoff Securities, ▸▸