Glenn Agre's Annual Market Report: Expectations for the 2023 Bankruptcy/Restructuring Cycle

The Great Recession of 2008 sparked the last large-scale restructuring cycle that lasted several years. Many industry professionals believe that we are on the precipice of the next major restructuring cycle due to the combination of inflation, government stimulus, rising interest rates, supply chain disruptions, geopolitical uncertainty, and the lingering impact of the COVID pandemic.

Since the Great Recession there have been significant changes in the capital markets that will differentiate the next cycle in several respects. In this article, we discuss several of the most impactful differences.

Depth of the Distress

In recent years, debt investors have enjoyed unprecedented low default rates and bankruptcy filings. At the same time, persistently low interest rates made it difficult to produce returns competitive with those available in the red-hot stock and crypto markets. As a result, debt investors eager to put capital to work have sought higher returns with corresponding higher credit risk.

Lulled by the historic low default rate environment, bankruptcy risk seemed a thing of the past. However, diminishing bankruptcy risk is not due to improved quality of every business, paradoxically, it was the result of the favorable lending environment that financed away immediate financial distress (i.e., “kicked the can”), thereby creating a self-perpetuating sense of safety.

Some of the same dynamics caused the Great Recession. Low interest rates led to excessive borrowing/lending, particularly in the housing market. Residential mortgage-backed securities (“RMBS”) repackaged home loans and spread the risk through Wall Street investment banks, some of whom ultimately failed, causing a massive credit contraction that crippled the broader economy and resulted in a spike in business bankruptcies in multiple industries.

The excessive lending that will launch the next restructuring cycle is not centered upon the housing market. Surely there will be increased mortgage default rates, but the debt that will be at the core of the next restructuring cycle is more industry/sector diverse than the Great Recession.

Like RMBS, the leveraged loan market and the rise of the CLO investment model has spread the risk of individual company loan defaults through structured credit that has been made available to a diverse range of businesses throughout the economy. Interest rate hikes will render many of these loans too expensive to refinance and necessitate restructurings.

And, of course, the COVID pandemic played its part. In 2019, many expected an economic correction and a wave of restructuring activity as a “wall” of maturities was fast approaching. At its outset, the conventional wisdom was that the pandemic would cause a tsunami of bankruptcies. However, other than a short-lived spike, restructuring/bankruptcy activity plummeted to historic 40-year lows.

Two factors caused this surprise. First, unprecedented government stimulus and spending succeeded in averting large economic damage for numerous individuals (rent deferral, stimulus checks, student loan deferral)

and businesses (PPP loans). Second, in part due to government pressure, private lenders showed surprising restraint to avoid defaults by allowing businesses more time to assess the pandemic's true impact. Lenders accepted amend-and-extend solutions that avoided the immediate maturity/default by punting it down the line until after the pandemic dust settled. Finance lawyers were very busy, but restructuring professionals not so much.

Many of these loans will soon require refinancing in a less hospitable environment. The combination of rising interest rates, inflation and the specter of a new recession will be a significant challenge for a diverse spectrum of businesses. We believe this is reflected in the fact that (according to Bloomberg) the amount of US debt trading at distressed levels has quadrupled in the last year (even before the onset of a recession).

Capital Structure Complexity

Creativity and competition in the finance market since the Great Recession has produced more complicated capital structures that will present restructuring challenges. Multi-tiered secured debt consisting of senior and junior lenders have become more common. Second lien, third lien and even fourth lien loans carry higher interest rates but are subject to intercreditor agreements that can limit junior lender rights in a restructuring.

Litigation regarding intercreditor issues has increased and will be a prominent feature in the next restructuring cycle. Several recent decisions have strengthened the hand of junior creditors and will likely embolden more junior creditor activism in restructurings.

For example, some courts have held that junior lien creditors can vote to support a plan of reorganization and receive equity interests in the reorganized debtor without violating an intercreditor agreement. See In re MPM Silicones, L.L.C., 596 B.R. 416 (S.D.N.Y. 2019). As is customary, the intercreditor agreement required the junior lenders to (a) "turnover" proceeds of collateral to the senior lender until the senior lenders had a full recovery, and (b) not support a plan of reorganization that the senior lenders did not support. Id. At 432-33. The court held that equity interests in the reorganized debtor were not "proceeds of collateral" and therefore not subject to turnover. Id. At 435. In addition, the court permitted the junior lenders to vote to support the plan because, as is common, the intercreditor agreement reserved the junior lenders' rights to protect their interests as "unsecured creditors," which they were due to their substantial deficiency claims. Id. At 428-32.

Distributions of debt and equity of a "spin-off" entity created pursuant to a Chapter 11 plan have also been held not to be subject to an intercreditor agreement because they were not "collateral" or "proceeds of collateral" of the debtor. See In re Energy Future Holdings Corp., 773 F. App'x 89 (3d Cir. 2019). Similarly, debt issued by the reorganized debtor could not be an "asset" of the debtor that could also be collateral. See In re Mallinckrodt PLC, Case No. 20-12522 (JTD), Nov. 5, 2021 Hr'g Tr. at 112.

Outside the bankruptcy context, lenders have engineered new "liquidity enhancing" financing structures that provide majority lenders with super-priority debt at the expense of non-participating minority lenders. One flavor of this (the so-called "up-tier" transaction) involves majority lenders under an existing credit facility (1) amending the credit agreement to create super-priority debt capacity, and then (2) providing some new money financing and "rolling up" the majority lenders' existing debt into the new super-priority debt tranche. These transactions have resulted in significant litigation challenges by minority lenders alleging, among other things, that they violate the "pro rata payment" provisions and the unanimous consent requirements for certain amendments to the relevant credit agreement. See LCM XXII Ltd. v. Serta Simmons Bedding, LLC, No. 21 CIV. 3987 (KPF), 2022 WL 953109, at *9-11 (S.D.N.Y. Mar. 29, 2022); In re TPC Grp. Inc., No. 22-10493 (CTG), 2022 WL 2498751, at *20-28 (Bankr. D. Del. July 6, 2022); ICG Global Loan Fund 1 DAC v. Boardriders, Inc., 2022 N.Y. Slip Op. 33492(U), *4-7, *14 (Sup. Ct., N.Y. County 2022); Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp., 72 Misc 3d 1218(A), 2021 NY Slip Op 50794(U), *17, *33-34 (Sup. Ct., N.Y. County 2021). Minority lenders have also claimed that up-tier financings breach the covenant of good faith and fair dealing. See ICG Global Loan Fund 1 DAC, 2022 N.Y. Slip Op. 33492(U), *12, *24. When companies that have employed this strategy file for bankruptcy, the complexity of the capital structure will provide fertile ground for litigation.

In another strategy, the debtor transfers material assets (often intellectual property) to an "unrestricted subsidiary" and then consummates a new financing (collateralized by the intellectual property) through the subsidiary with a subset of the debtor's existing lenders (who provide some new incremental liquidity and exchange existing debt into the new structure). The transfer of the assets reduces the collateral value securing the debtor's existing debt and provides fresh collateral to support the unrestricted subsidiary's "new" debt. These financings have been challenged by existing lenders whose collateral was diminished and will most certainly become contested intercreditor disputes in any ensuing bankruptcies.

Debtors and (some of) their creditors have created a significant pipeline of complex capital structures with the potential for extensive intercreditor disputes. This "creditor-on-creditor violence" is double- edged for the debtor's restructuring process. On the one hand, debtors often benefit from creditors fighting each other for the benefit of some rather than collaboratively fighting the debtor for maximum recovery for the benefit of all. On the other hand, intercreditor disputes often require some amount of litigation to resolve either by settlement or by the court. Inevitably, the litigation delays the larger restructuring and is time-consuming and expensive for all parties. Decisive and innovative litigation strategies and commercial dealmaking will be the difference between success and failure for complex capital structure creditors in the next restructuring wave.

These structures may also impact the plan voting process. For example, an "uptier" financing creates a new class of senior debt against the same debtors and collateral that secured the debtors' existing debt. The senior debt may also impose an intercreditor agreement on the existing debt thereby limiting the existing minority lenders' ability to participate in a future bankruptcy process. And the debtor may have a friendly class in the holders of the new senior debt that can serve as a cramdown class to facilitate a bankruptcy restructuring if one is necessary. Non-participating lenders—now subject to an intercreditor agreement—will need to develop a litigation strategy to protect their interests.

This scenario is playing out for the first time in the bankruptcy context in the Chapter 11 case of Serta Simmons commenced on January 24, 2023. See In re: Serta Simmons Bedding LLC, et al., Case No. 23-90020 (DRJ) (Bankr. S.D.T.X 2023). There, the debtor entered into an agreement with its "uptier" financing parties to support a plan of reorganization where debt and equity of the reorganized debtor would be delivered to the "uptier" lenders and, in contrast, proposes that the minority non-participating first lien lenders receive a 4% recovery. To cramdown the plan on the non-participating lenders, the debtor commenced an adversary proceeding to confirm the propriety of its "uptier" financing and, consequently the classification of its "uptier" lenders as a separate voting class. In doing so, the debtor seeks to convert the non-participating lenders current state court lawsuits into an adversary proceeding before the bankruptcy court, where it asserts that the litigation is the only obstacle to quick confirmation of a plan of reorganization. This case will be closely watched to determine if this strategy will succeed.

Pre-Negotiated/Pre-Packaged Bankruptcies

A strong trend has developed in favor of highly organized Chapter 11 restructurings where the plan is negotiated and has key creditor support prior to commencing a bankruptcy case. The two forms of this trend are (a) pre-negotiated bankruptcies where key creditors and the debtor sign a Restructuring Support Agreement (RSA) or Plan Support Agreement (PSA) which memorializes the principle terms of a plan of reorganization to be filed and voted upon after filing bankruptcy and (b) pre-packaged bankruptcies where the debtor and all relevant creditors agree upon (and cast votes to accept) a plan of reorganization before the bankruptcy filing. The main process difference between the two is that a pre-packaged bankruptcy is likely to be confirmed on a quicker timeframe than a pre-negotiated bankruptcy.

The advantage of these approaches is a higher certainty of outcome/success through a shorter, more efficient, and less expensive bankruptcy process. Pre-packaged bankruptcies are ideal for "balance sheet" restructurings where the debt to be restructured is financial/funded debt owed to sophisticated financial investors. In these cases, the ordinary course trade debt is left "unimpaired" and paid in full and therefore does not need to vote on the reorganization plan.

Where trade debt must be impaired, pre-packaged bankruptcies encounter difficulties that often cause the parties to choose the pre-negotiated path instead. The restructurings that occurred during the COVID pandemic (particularly in the retail and energy sectors) often pursued pre-negotiated bankruptcies because there was substantial trade and other unsecured debt that could only receive minimal, if any, recovery in the bankruptcy.

We expect that parties will continue to prefer the efficiency of organized bankruptcy filings (as opposed to protracted battles) wherever possible during the next cycle.

Independent Director Investigations and Settlements

In cases where there are potential estate causes of action (e.g., avoidance actions, director and officer liability), it has become common for the debtor to empower independent directors with the authority to investigate. The independent directors hire separate advisors and investigate, prosecute and/or, most frequently, settle the claims because the debtor wants them resolved.

Debtors use independent director investigations as a strategy to reduce the disruption and delay of litigating the claims during the bankruptcy process. If the investigation can be completed before or soon after the bankruptcy filing, the debtor can procedurally alter the posture of the dispute in bankruptcy. In the absence of the investigation and settlement, the official committee of unsecured creditors and/or other creditors would invoke the discovery rights in bankruptcy to investigate and seek standing to prosecute the estate claims. The committee/creditor needs only to prove to the court that there are colorable claims that are economically worth pursuing—a relatively modest burden similar to surviving a motion to dismiss.

Where the debtor presents an independent investigation/settlement, the debtor seeks to resolve the dispute by simply meeting the low burden for court approval of settlements under Bankruptcy Rule 9019. In this context, the committee/creditor's burden substantially increases and requires it to prove that the settlement is not within the lowest rung of the range for reasonable settlements of the matter. In this context, the committee/creditor's role is subordinated from principal investigator to more of a mild procedural check on the debtor's independent director's judgment regarding the litigation.

Settling significant potential litigation claims removes the delay and uncertainty of process and can often pave the path for a speedier and more efficient plan confirmation process. We expect that independent director investigations/settlements will play a significant role in the next round of restructurings where there is any meaningful litigation embedded in the process.

Section 363 Sales in Lieu of Plan Process

Another strategy to expedite a bankruptcy is to pursue a sale of all, or substantially all, of the debtor's assets so that the business can continue to operate under new ownership without the litigation overhang of complex disputes. Here, the operating assets are sold "free and clear" of prior liens and interests (and, if possible, successor liability) with all unresolved claims being effectively channeled to the remaining assets, if any, in the debtor's estate. For example, a debtor with significant mass tort liability might settle with some of its tort claimants and propose an asset sale where some of the proceeds are earmarked to fund the settlement. If the sale does not produce proceeds in excess of secured claims, unsecured creditors (including non-settling tort claimants) will receive little or no recovery.

Similarly, senior secured creditors may prefer a quick sale process because (depending upon the relevant intercreditor agreement's terms) it provides junior secured creditors with fewer options to protect their interests. The core of an intercreditor agreement is that junior lenders will not interfere with the senior lenders' efforts to liquidate collateral as long as the junior lenders' lien attaches to collateral proceeds in excess of the senior lenders' recovery. Junior lenders may criticize the proposed bidding/sale process, but they typically cannot object to the actual sale, which will conclusively determine the value of the debtor's assets and the ultimate recoveries of senior and junior lenders.

In contrast, if the senior lenders seek to recover via a plan of reorganization, junior secured creditors often have (as noted above) more opportunities to challenge the plan based upon the confirmation standards, which are more rigorous than a mere 363 sale. Junior lenders also have (as described above) more opportunities to participate in plan recoveries, especially where reinstatement of the senior debt is possible.

We expect that senior lenders will push for more asset sales, particularly where the sale can truncate an otherwise lengthy litigation regarding claims allowance and plan confirmation.

Reinstatement

With rising interest rates, we expect that many debtors and junior creditors will seek, wherever possible, to preserve the value of the low interest rates on existing senior secured debt by “reinstating” the senior debt via a Chapter 11 plan. Debtors and junior creditors may also try to use reinstatement as a strategy to avoid any “makewhole” premium associated with the senior debt. See In re Mallinckrodt PLC, Case No. 20-12522 (JTD), Nov. 5, 2021 Hr’g Tr. at 44. At least one court has disallowed such a makewhole premium and held that reinstatement eliminates the existence of an automatic default due to the bankruptcy filing. See id. at 107-09. By curing all existing events of default, reinstatement may also implicate a senior creditor’s rights under an intercreditor agreement, which are often predicated on a continuing event of default. See id. at 112-13. This may even be true if the junior secured creditors receive cash distributions under a plan that does not pay a senior creditor its makewhole premium or post-petition interest.

Due to the need to secure DIP financing and other strategic considerations, debtors often work collaboratively with their senior secured creditors. Interest rate disparities may drive a wedge in this relationship in cases where reinstatement can create material value. Senior lenders will resist. The next round of restructurings will require effective and commercial strategies for debtors and senior and junior lenders to guide the reinstatement issue to the best possible outcome.

Covenant Lite

In the period leading up to the Great Recession, highly competitive credit markets seeking yield resulted in credit agreements and indentures with fewer covenant protections for the lenders; so-called “covenant lite” deals. Similar competition in recent years has given borrowers the ability to negotiate lending terms with less robust covenant packages. Since covenants are designed to raise red flags regarding credit quality and increased risk of default, fewer covenants means that creditors have less opportunity to bring the borrower to the negotiating table before a credit default occurs. Borrowers are often not proactive to acknowledge and address their financial difficulties and, by their nature, often wait until the last minute (and only when forced) to engage with their creditors. This phenomenon often results in less organized, less efficient and more expensive bankruptcies, as was the case during the Great Recession restructuring cycle. Creditors during the next cycle will need to develop strategies to proactively engage with borrowers and, where necessary, creatively use the limited covenants that they have to compel an unwilling debtor to the table. Success on this score will be key to consummate value maximizing transactions.

Private Equity & Private Credit

One significant (and growing) segment of the finance market will likely experience less litigation; private credit (a/k/a direct lending) – where an investment fund or small “club” of funds is the primary financing source for a company rather than the traditional syndicated bank or public debt markets. Private credit has financed a significant portion of portfolio companies owned by private equity. The resulting capital structures are simpler with fewer parties necessary to negotiate a restructuring. Because private credit and private equity parties frequently do business with one another, their business interest in preserving their broader relationship can facilitate quicker and more consensual restructurings. Due to both sides’ interest in maintaining the “private” nature of their investments, many of these restructurings can occur out-of-court and draw less publicity.

De SPAC Company Restructurings

Since 2019 there has been explosion of SPAC financings that have ultimately resulted in de SPAC transactions where the SPAC merges with a private company that then becomes a public company. The frenzy of investing in SPACs will generate a pipeline of companies needing restructuring in a more challenging economic environment.

Some de SPAC companies have already filed for bankruptcy (e.g., Enjoy Technology filed bankruptcy nine months after its de SPAC debut) and numerous others have begun issuing "going concern" warnings. Shares in companies made public via SPAC in 2021 have dropped below 50% in value. Many SPAC transactions involved startups with little or no track record and many involved businesses in the technology sector, which has seen a significant market sell off. Many of these companies will experience operational challenges and need additional capital, which will present significant challenges with high interest rate borrowing costs and a more cautious finance market that is less willing to take risk on leveraged loans. As a result, we expect that the progeny of SPACs will create the need for restructurings.

Third Party Releases

We expect the ongoing battle regarding the permissible scope of releases that can be provided in a Chapter 11 plan will continue in the next cycle. In particular, there has been much public debate concerning non-consensual third-party releases, where non-debtors receive a release from legal claims held by third parties as part of a bankruptcy proceeding of a separate entity. That issue came to the forefront in the Purdue case, where the U.S. District Court for the Southern District of New York held that the bankruptcy court lacked authority to approve third-party releases granted to members of the Sackler family as part of Purdue's Chapter 11 case. Courts in certain other jurisdictions, however, have continued to approve nonconsensual third-party releases, including in the recent Boy Scouts Chapter 11 case in Delaware. Given the inconsistent law on this point in different jurisdictions, we can expect companies to continue to engage in "forum shopping," especially when they wish to utilize a Chapter 11 proceeding to shield their owners, management, and other third parties from legal claims. This may soon reach the Supreme Court to resolve the circuit-split on this important issue.

What Lies Ahead

We do not have a crystal ball, but based upon available data and instinct, we expect a significant increase in restructuring activity in the near term. The final catalyst remains to be seen. The collapse and bankruptcies of crypto market participants may have a ripple effect on adjacent business and investors. A recession is the most obvious concern. Regardless, the next large restructuring cycle will present robust opportunities for advisors and investors with effective litigation and dealmaking strategies to enjoy success in a challenging economic environment. Your Glenn Agre team combines the experience and insight of seasoned transactional restructuring lawyers and insolvency litigators to provide the full suite of litigation skills and commercial judgment to help guide our clients to the best possible outcome in this next wave of restructurings. We look forward to working with you and fighting the good fight.

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