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## **How Private Funds Can Profit From the Next Wave of Restructurings**

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## Introduction

In light of ongoing turmoil in the credit markets, the continuing uptick in the default rate, and the increasing number of sizeable corporate bankruptcy filings, the time is right for private funds to consider how best to profit from this turn in the economic cycle. Morgan Lewis's nationally ranked Restructuring Practice—consisting of attorneys throughout our international network—stands ready to assist you in exploiting these opportunities.

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## Existing Portfolio Companies That Encounter Difficulties

### Out-of-Court Workouts/ Prepackaged or Prenegotiated Bankruptcies

In past restructurings, knowledgeable participants have often preferred out-of-court workouts to in-court Chapter 11 proceedings, due to the speed, flexibility, and reduced costs associated with the out-of-court scenario. This strategic preference is likely to be accentuated even further in coming restructurings, given the uncertainties injected into Chapter 11 proceedings by the recent bankruptcy reform legislation, notably the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 Act).

Among the provisions incorporated into the Bankruptcy Code in 2005 were the following:

- **Exclusivity limitation:** Extensions of the “exclusivity” period, wherein only the debtor in possession can file a plan of reorganization, are now statutorily capped at 18 months from the bankruptcy filing. This increases the risk of competing plans being proposed by warring parties in interest, which could threaten the likelihood of reorganization and the preservation of enterprise value, and lead to lengthy and uncertain confirmation litigation.
- **Restrictions on key employee retention plans (KERPs):** KERPs, used to incentivize management, are now subject to sharp restrictions, which have led to complex and uncertain litigation in the bankruptcy courts as to how to formulate arrangements that comply with the new statute.
- **Expansion of vendor rights:** The 2005 Act bestowed enhanced reclamation rights and administrative expense (i.e., first priority) claims to vendors, thereby increasing the cash needs of the debtor to fund and exit the bankruptcy.
- **Expansion of landlord rights:** The 2005 Act imposes an absolute deadline of no more than 210 days after the bankruptcy filing for the debtor to assume its

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nonresidential real estate leases. Previously, the debtor could be granted extensions of many more months or even years. The revised deadline could have dramatically negative consequences for distressed retailers that are considering their lease portfolios in connection with a bankruptcy filing, as they may now be forced to make premature decisions with long-lasting consequences.

Other recent developments in the marketplace and in the bankruptcy courts also suggest that out-of-court workouts may be the preferable route, if achievable. For example:

- **Difficulty of obtaining exit financing** due to the current credit market conditions.
- **Proliferation of second-lien financings:** The case law regarding the enforceability of waiver and subordination provisions found in second-lien documents is limited and contradictory, suggesting that negotiated resolutions outside of bankruptcy should be explored.
- **Rule 2019 litigation:** Bankruptcy Judge Gropper, in his recent *Northwest Airlines* decision, held that a previously obscure bankruptcy rule requires that funds sitting on unofficial committees in Chapter 11 cases disclose the details of their trading positions, including purchase prices. The judge in *Scopac* has ruled to the contrary. This is rapidly becoming a flashpoint in leverage struggles among banks, funds, and debtors, and adds more litigation uncertainty and expense in the Chapter 11 process.

In those situations where an out-of-court workout is not possible (e.g., because of substantial holdouts), a prepackaged or prenegotiated bankruptcy may avoid certain of the pitfalls described above associated with Chapter 11 proceedings.

## Traditional Chapter 11 Proceedings

In many cases, private funds may instead wish to restructure, or sell, a troubled portfolio company through a traditional Chapter 11 proceeding. This may be the case where the magnitude of business or legal problems faced by the company, or the degree of enmity among the various constituencies, simply cannot be dealt with in a considered and comprehensive manner without the full arsenal of substantive and procedural provisions of Chapter 11.

For these situations, we note that the 2005 Act also contains some potentially helpful provisions.

- **Cross-border bankruptcies:** The new Chapter 15 of the Bankruptcy Code further harmonizes U.S. bankruptcy law with that of other jurisdictions, and should make multinational insolvencies smoother and more predictable.
- **Expansion of derivatives safe harbors:** The Bankruptcy Code now permits cross-product netting and broadens the definitions of derivative products to take market developments into account and to permit counterparties to liquidate their contracts.

- **Expansion of “ordinary course” preference defense:** The 2005 Act enhanced the ability of recipients of prepetition payments to keep amounts received in the ordinary course of business.

## Investing in Restructurings Where Private Equity Funds Were Not Previously in the Deal

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In the coming wave of restructurings, private equity funds will presumably wish to consider investing in companies that were not previously in their portfolios. Such investments can take various forms:

- **Purchases of debt:** This can be motivated either by the prospect of cash or debt distributions in respect of loan, bond, or trade claims, or equity distributions on account of such claims (i.e., “loan to own”). In connection with such purchases, private equity funds must bear in mind the uncertainties regarding the enforceability of second-lien waiver and subordination provisions.
- **Purchases of equity:** In certain cases, this asset class may now be attractive, given the recent trend toward appointment of equity committees (historically, a rare event) over the vigorous objection of other constituencies in the *Delphi* and *Oneida* Chapter 11 cases.
- **Purchases of assets:** Given the previously described risks and uncertainties in Chapter 11 proceedings, more cases may be filed in order to effect auctions of specified assets, or even of the company itself, under Section 363 of the Bankruptcy Code, rather than engaging in a traditional restructuring pursuant to a Chapter 11 plan of reorganization. Since assets can be sold “free and clear” of liens and claims, and since antiassignment clauses in leases and contracts are generally unenforceable in bankruptcy, the purchase of assets in a bankruptcy sale may be the most viable alternative in a distressed situation.

## Non-U.S. and Cross-Border Restructurings

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Many companies today have assets, operations, and creditors in various jurisdictions around the globe. If such a company encounters financial difficulties, it may need to commence insolvency proceedings in multiple jurisdictions, or at least effectuate a workout implicating the laws of multiple jurisdictions.

Fortunately, in this regard, many nations have been adopting reorganization statutes modeled at least loosely on the provisions of U.S. Chapter 11. Similarly, as noted previously, the 2005 Act enacted Chapter 15, which was intended to facilitate and harmonize cross-border restructurings. Thus, while multinational cases present special issues and require thoughtful coordination, private equity funds seeking opportunities in the next restructuring cycle should not confine their attention to U.S. debtors.

## How Morgan Lewis Can Help

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The Restructuring Practice, co-chaired by Howard Beltzer and Richard Toder, is an integral part of the firm’s Business and Finance Practice, and works closely with our

private equity attorneys in aggressively representing the interests of private equity sponsors and their portfolio companies.

Relevant representations of *debtors*, *private equity funds*, and *asset purchasers* include the following:

- We are debtor's counsel to two of the largest retailers to file thus far in the current cycle, Linens 'n Things and Mervyn's.
- Our partners have been lead counsel for United Pan-Europe Communications NV (UPC), a Dutch telecommunications company indirectly owned by Liberty Media, which equitized more than €10 billion of debt through concurrent proceedings in New York and Amsterdam. They have also represented Stolt-Nielsen, a large Norwegian shipping company, in its out-of-court restructuring, and Camelot Music, a leading U.S. record chain and an Investcorp portfolio company with more than 400 store locations, in its Chapter 11 proceeding (which was extremely successful, with Camelot actually buying a competitor upon emergence from bankruptcy). Furthermore, they have represented Mirant and its affiliates in their Chapter 11 cases. On the equity side, they have represented UPC in the Chapter 11 case of its subsidiary, UPC Polska, and the Otto Group as owners of the Spiegel companies (including Eddie Bauer). They also assisted McCown De Leeuw & Co. in connection with distressed portfolio companies. Through these and other matters, our attorneys have been significantly involved in many of the largest cross-border restructurings in recent years.
- Other recent Morgan Lewis debtor representations have included Century/ML Cable Venture, an Adelphia debtor (the plan involved sale of the company, full payment to creditors, and a substantial distribution to shareholders); Riverstone Networks (similar result); One Price Clothing Stores; Kleinert's; American Cellular (tender offer and backup prepack); Zany Brainy (successfully sold in bankruptcy); and DecisionOne (prepack completed in 35 days).
- Frequent representation of private equity funds in connection with distressed investments and asset sales.
- Frequent representation of other purchasers of assets in bankruptcy sales.

We would be pleased to meet with you to further discuss how we can help you take advantage of these opportunities.

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