CHILMARK ON:
RESTRUCTURING

SUMMER 2020 PUBLISHED BY CHILMARK PARTNERS

The Ceremony of Innocence is Lost

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As the present now
Will later be past
The order is rapidly fadin'
And the first one now
Will later be last
For the times they are
a-changin'

– Bob Dylan, *The Times They Are A-Changin'*

COVID-19's impact on people, businesses and economies around the world has been so rapid and precipitous that we don't yet understand the full scope of the damage. One thing we do know even now is that the capital structures of many companies are going to need to be restructured in the not-to-distant future.

We've already seen a large increase in the number of businesses seeking bankruptcy protection: 94 large companies with a total of $132 billion of funded debt have filed for Chapter 11 this year alone. Compared to the same period last year, the number of large Chapter 11 filings has increased 68% and the cumulative funded debt of those companies has more than doubled. We expect this trend to continue until the virus is contained.

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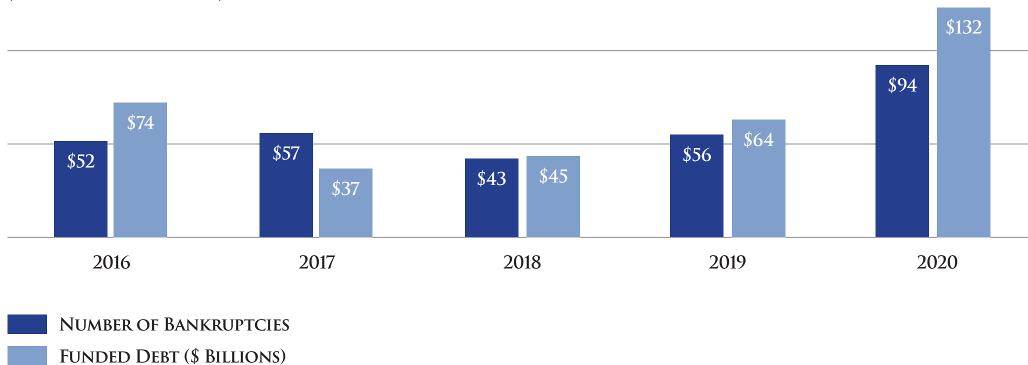
Chapter 11 Bankruptcies through July 15, 2020
Among Companies with over $50 million of Funded Debt

(Source: Chilmark Partners)



The U.S. Bankruptcy Code has guided debtors and creditors in navigating economic challenges and precipitous downturns for decades, including during and after the post-9/11 recession in the early 2000s and the Great Recession of a decade ago. But the bankruptcy environment has evolved significantly since 2009, and the scope of changes for debtors and creditors is hard to overstate.

Following the recession of 2009, Congress and regulators attempted to protect the public and the financial system by restricting traditional banks' ability to provide leveraged loans. Like water running downhill, however, capital has found its way to leveraged borrowers through the proliferation of other intermediaries: collateralized loan obligations funds (CLOs), business development companies (BDCs), and direct lenders.

Since 2009, loans held by CLOs have doubled to more than $600 billion, representing half of the $1.2 trillion leveraged loan market. Assets under management for BDCs—which typically lend to middle-market companies—quadrupled during the same time period, and direct lending platforms have become increasingly prevalent with assets under management now topping $250 billion.

These lenders, like the traditional banks that came before them, typically employ leverage to enhance returns. They are also subject to some structural limitations that decrease their flexibility when it comes to restructuring troubled companies. CLOs, for example, have certain self-imposed restrictions: while they may be able to accept equity in exchange for debt in a deleveraging transaction, they are often ill-equipped to participate in a new money investment.

As funds compete with one another to deploy that capital, negotiating leverage has shifted toward borrowers.

The reshuffling of players in the speculative-grade debt market has coincided with a sustained period of historically low interest rates. This macro environment has not offered sufficient yield to fund the needs and desires of the real parties in interest — pension funds, insurance companies, and the investing public — forcing investors to accept greater levels of risk for a given amount of return.

The combination of investors' thirst for yield and alternative credit providers' ability to offer it (albeit not without risk) has led to an oversupply of capital for leveraged lending. As funds compete with one another to deploy that capital, negotiating leverage has shifted toward borrowers. New issue lenders have lost their ability to dictate terms in credit documents, and historical protections afforded to senior lenders have been whittled away. First came the removal of financial covenants. Between 2015 and 2018, the share of "covenant-lite" loans in the leveraged loan market increased from 64% to 79%. With covenants largely removed, borrowers began pushing for increased flexibility on other terms, including the ability to issue new debt, move assets, and pay dividends.

The confluence of these changes in the credit markets has created an entirely new rulebook for working out troubled companies — one that does not necessarily preserve the spirit and principles set forth in the Bankruptcy Code. The Code dictates few outcomes and mainly establishes ground rules. Its approach is to require negotiation among parties, and it has its very own judiciary to interpret and enforce it. But the Code has held three things dear:

1 The primary goal of rehabilitating the debtor

2 The requirement that similarly situated creditors should be treated similarly

3 The requirement that liens on collateral security be respected

Sharp-elbowed creditors have devised a way to extract value from their similarly situated brethren.

The first question a leveraged company facing major trouble must answer is where to turn for the cash it needs to operate. The most obvious answer has always been, and is still, its existing constituencies, whether equity or debt holders. These are investors who have already signed on to the company and its future.

When loans were held by individual banks or small groups of banks, the company had few options but to accept the terms and restrictions placed on any new capital. In the current environment, distressed borrowers are finding that they can take advantage of their credit documents and competition among creditors to strike deals that are favorable to the company and certain commanding stakeholders.

Three novel transaction structures have emerged so far:

1 The transfer of collateral away from secured lenders

2 The use of non-pro-rata exchange provisions to restructure the entire priority scheme within a credit

3 Exploitative financings

There has been significant coverage of the collateral transfer tactic since the 2016 J.Crew transaction that transferred $250 million of intellectual property to unrestricted subsidiaries. Taking advantage of borrower-friendly terms in its credit agreement, J.Crew was able to transfer intellectual property outside the reach of its lenders, and was free to borrow against those assets to address unsecured debt maturities.

The second notable transaction structure is the non-pro-rata exchange, which was executed in 2017 by certain creditors of denim brand NYDJ. This group acquired just over 50% of the company's first lien term loan and engineered a transaction in which it amended the credit agreement to permit an exchange that effectively subordinated the term loan lenders not in the group. This was a controversial amendment, and would not have been conceivable were it not for borrower-friendly terms in the original credit agreement. The minority lenders litigated, and the case was ultimately settled. The end result, however, was that a group of lenders was subordinated to the majority holders of the exact same debt instrument. Like the asset-stripping J.Crew transaction, the NYDJ non-pro-rata exchange highlighted how borrower-friendly credit documents can expose creditors to risks that were once unimaginable.

Both of these tactics were in play in the contentious Serta Simmons transaction earlier this year. The borrower negotiated with competing groups holding the same debt instruments — one of which was pursuing a collateral transfer transaction and the other a non-pro-rata exchange — to raise $200 million of new debt capital and eliminate a significant portion of its existing debt.

While the non-pro-rata exchange transaction that was ultimately executed was beneficial for the equity sponsor — enabling it to continue its turnaround effort of a highly leveraged business without needing to put up additional capital itself — the creditors who did not participate in it were effectively subordinated to the group that did. Without the contractual loopholes in the credit agreement, the likely outcome would have been a more universal negotiation over ownership of the restructured entity and a broader opportunity to invest in it.

Creditors that are ill-equipped to invest new capital can see their recovery dwindle to nothing…

Even in court-supervised Chapter 11 cases, sharp-elbowed creditors have devised a way to extract value from their similarly situated brethren. Sponsoring creditors structure Chapter 11 plans to provide pro-rata treatment among creditors, but take advantage of one big opening — dilution from a

new capital financing. Sometimes new investment is needed by a company, but opportunistic creditors have seized upon that need to fashion a way to exploit the others.

The terms of the financing have come to be complex, hard to untangle and layered with other terms to create economic advantage for the sponsoring creditors. Under the guise of promoting a quick and efficient process, there is rarely a market test, and in some cases participation is only open to the sponsoring creditors. This practice has largely been allowed on the theory that any favorable economics are attributable to the new money as opposed to recovery on the old. Even when participation in a new money investment is opened up to a larger group, creditors that are ill-equipped to invest new capital can see their recovery dwindle to nothing if the new money financing terms include provisions — such as make-whole premiums and warrants — that swallow the lion's share of the value of the reorganized entity.

The subscription rights offering is one form of financing for distressed borrowers, and — done fairly — it is a useful tool. Pricing fresh capital for a troubled company is notoriously difficult, and a rights offering can solve that dilemma by giving creditors the opportunity — but not the obligation — to invest new money. But the potential for exploitative pricing has made it possible for rights offerings to deliver unfairness as well. If "rights" in a rights offering relate more to the Rights of Man than to Might Makes Right, the tool is sensible, valuable, and fair. All that's needed is for subscription rights to be transferable, so unable or impecunious holders have something to sell, and for fees and benefits of backstop financiers to be reasonable.

To be sure, the Code allows for less than full agreement among creditors, and applying pressure to minority creditors is as old as the Code itself. Tight timelines, financing hurdles, death-traps and cram downs of junior interests are all traditional tools, but in today's environment those tools are being pushed to the extreme.

How has this changed the traditional key tenets of the Bankruptcy Code? Similarly positioned creditors are no longer always being treated equally. Those creditors able to cut a deal with the borrower generally get the benefit of an improved position, while non-participating creditors are disadvantaged. The supply of credit has allowed borrowers to pursue out-of-court restructurings that are not governed by the Code, often impairing the strength of lenders' liens. Different tactics but similar outcomes can occur in a bankruptcy. When a new money financing is sponsored by a dominating creditor, those who cannot or do not wish to participate in it can be crushed.

These are tough times to be a creditor of a distressed company. In the words of Paul Newman, "if you're playing a poker game and you look around the table and can't tell who the sucker is, it's you."

Yes, as through this world I've wandered / I've seen lots of funny men; / Some will rob you with a six gun, / And some with a fountain pen.

– Woody Guthrie,
The Ballad of Pretty Boy Floyd

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