US companies are benefiting from a red-hot liquid lending market. Banks and institutional investors are eager to provide corporate financing and participate in as many deals as possible by issuing various forms of debt. This liquidity has funded restructurings and generally kept bankruptcy filings at relatively low levels. However, economic cycles dictate that a downturn will be inevitable at some point in the future. This roundtable discussion examines current market trends to identify where the seeds of the next bankruptcy wave are being sown. 

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Sprayregen: What factors do you attribute to the decline in corporate bankruptcy filings? Does the decline reflect overall improvement in corporate performance, the health of the economy, the increased willingness of banks and other secondary lenders to extend credit, or the ability of companies to obtain capital through other means, such as bond or sub-debt issuances, private equity investments, stock offerings, and so on?

Newman: Many factors have led to a reduction in corporate bankruptcies during the last few years. A generally strong economy has led to improved operating performance and cash flow for many companies. Similarly, interest rates at or near all-time lows have reduced the cost of capital for most companies. However, the most significant factor behind the reduction in bankruptcies has been the dramatic increase in availability of capital – particularly debt capital – to companies. In recent years, banks have become more aggressive lending to companies near financial distress in connection with “rescue financing”. Similarly, the explosive growth in hedge funds, especially those dedicated to distressed situations, has made billions of dollars of capital available directly to companies. Absent this capital, many of these companies would need to pursue a restructuring.

Patton: The emergence of new, risk-tolerant lending sources, including hedge funds, and the general availability of cheap capital and cheap debt are the primary sources behind the recent decline in corporate bankruptcy filings. Additionally, an increasing sophistication among lenders and the work-out community has led to an increase in out-of-court restructurings.

Loughlin: The availability of capital looking for higher returns in a generally flat stock market and low interest rate environment appears to be driving the credit markets appetite for taking increasing levels of risk. The rapidly growing hedge funds are willing to provide capital to companies that would otherwise be forced to restructure today.

Glassman: A far greater percentage of the available capital is now managed by hedge funds, who bring a new dynamic to the market in that they are more nimble and make investment decisions much more quickly than other types of investors. The overall availability of financing has helped many ailing companies to survive, and those companies that operate on a leaner basis have been able to achieve strong investor returns and increase enterprise value in good times.

Pernick: Even banks, which in past years limited themselves to relatively ordinary and traditional loans, now have divisions that get involved in debt and equity transactions that are quite different from the traditional bank loans of the past.

Mayerson: There is no doubt that with so few deals around, competition among lenders is high. Many lenders are certainly willing to make riskier investments, and hedge funds are a strong example of this trend. In a low interest rate environment, with the abundance of opportunities that exist for companies to obtain financing and refinancing, it is clear that these factors have had a significant impact on the number of bankruptcy filings.

Schnelling: I’m not so sure that the decline in bankruptcies reflects improving profits. Ford recently announced its profits were down 20 percent. The automotive sector is in a disastrous slump. The airline industry is hanging on by its fingertips. All the companies that are ancillaries to these businesses are in deep trouble. The main reason for the decline is the fact that more liquidity is around. The fact that cash flow loans have risen is very unusual and provides an insight into the amount of liquidity in the market. Given the continued volatility in the stock market, investors are looking for other places to go, and two alternatives are to buy assets perceived to be distressed and turn them around, or to lend to distressed assets that can be revitalised.

Sprayregen: What do you anticipate will be the impact of the rise in second lien loans?

Glassman: A large contributor to the rise in second lien loans is the tension between equity and first lien lenders. In addition, in such a competitive environment, this rise clearly demonstrates a bit of innovation on the part of banks. But there will be some fallout as a result of second lien loans to borrowers whose capital structure must be modified to reflect the real value of the underlying enterprise.

Patton: The recent increase in second-lien loans will lead to an increase in bankruptcy filings in the last quarter of 2005 and 2006, in much the same way the junk bond market of the late 1980s contributed to the surge in corporate bankruptcies in the early 1990s. Unlike junk bonds, however, these new instruments are secured. The coming bankruptcies driven by second-lien debt will see intense valuation litigation among the various stakeholders, principally between the unsecured bondholders and the second lien holders.

Schnelling: Second liens load the company up with debt and of course it does not get paid until the first lien debt is settled. For companies, it does tend to leave very little room to manoeuvre. If the money that is borrowed is not spent in a way that increases profitability, it means the company may become insolvent on the balance sheet much more quickly. An emphasis needs to be placed on implementing the correct operational restructurings and ensure that the company is being moved forward with the assistance of that money. But management too often overlook the operational aspects of a restructuring because it’s so much harder to deal with them.

Second liens are very much a function of loose credit and high liquidity. They are also driven by hedge funds, which have become enormously popular due to the returns they have made for high net worth investors. But there are so many hedge funds around that they are chasing worse and worse deals. As a consequence, they are putting money out on second liens and offering cash flow loans, which are counter-indicative and causes problems. There is not much left in the market rated AAA and AA. Indeed, more than a third of second lien loans are rated CCC+ and below. That says it all. Who puts money out for CCC in a second lien position in what is obviously a distressed company?

Mayerson: The rise in second lien loans is making money available to vulnerable and riskier enterprises that may have
By effectively pledging all of their assets and becoming highly leveraged in a relatively positive economic environment, companies who access second lien financings may be limited, or perhaps even stymied in their restructuring alternatives.

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otherwise struggled to gain access to capital. Although this type of lending occupies an important part of the market, second lien loans place increased risk on trade creditors in Chapter 11 situations.

Pernick: The increased use of second lien financing may ultimately result in an increase in corporate bankruptcy filings, because, in large measure, this financing vehicle has made it possible for marginal and otherwise highly leveraged companies to access additional capital, without materially changing their equity structure. Ultimately, these highly-leveraged companies will react negatively to less significant economic fluctuations, including interest rate changes. By effectively pledging all of their assets and becoming highly leveraged in a relatively positive economic environment, companies who access second lien financings may be limited, or perhaps even stymied in their restructuring alternatives.

Newman: Second lien financings are generally structured when a company does not have access to debt capital on an unsecured basis and does not have sufficient collateral value to issue debt on a first lien basis. By definition, these loans are considered more risky and consequently, are more expensive for the borrower. The higher costs often include significant fees, higher rates and “tight” covenants. As a result, these companies could have little room for error going forward. The higher interest rates will put further financial strain on the company. Similarly, the “tight” covenants will increase the likelihood of future defaults. Another key consideration in the growth in second lien financings is the corresponding impact on companies’ ability to raise additional capital in connection with a Chapter 11 restructuring. Companies that have fully pledged their assets through first and second liens will likely find it harder to raise DIP financing.

Loughlin: In recent cases I have been involved with, bank lender fatigue combined with the inability to make scheduled debt amortisation payments, were pointing toward an imminent restructuring or Chapter 11 filing. In one case the banks were taken out completely, while in the other, the next two years of principal payments were in effect “prepaid” with the proceeds of the second lien debt financing. In essence both companies were given the time to work through their issues. Time will tell if they ultimately will be successful, as they remain highly vulnerable businesses and, now have a significantly higher cost of capital.

Sprayregen: Will capital structures with second lien loans be harder to restructure?

Mayerson: At a glance, many market participants may feel that reorganisation may become more difficult if you see second lien loans as another layer of secured debt. However, from a practical point of view, in many cases these new second lien debts are simply taking the place of junk bond financing. In the past, in cases where the US trustee placed bondholders and trade debt on one committee, due to the unique profile of junk bond holders, it created gridlock on a creditors committee, and you were left with nobody to negotiate with. And there are specific tools for dealing with secured creditors that we don’t have for unsecured. So I do not believe second liens will have a significant negative impact on the negotiation of the plan of reorganisation. However, I do believe that where difficulties may arise is at the outset when negotiating DIP financing. In most cases, it is the first lien lenders that provide the DIP, and they will want to prime the second lien lender, which is not so easy to achieve. In essence, I believe this will make negotiations more challenging before a case is filed.

Loughlin: The second lien lenders will be seeking to have their say in the case and topics like adequate protection payments and valuation issues will arise and likely become issues. Many of these second lien lenders are there in place of what would have been subordinated debt in the last restructuring cycle. Inter-creditor terms of such agreements are fairly broad and diverse, but it is clear that there will be another secured creditor at the table seeking to influence the direction and the outcome of the restructuring process. Divergent interest among the secured lenders could lead to adding complexity and cost to the restructuring process.

Newman: On the one hand, secured creditors (even if secured by a second lien) have greater rights than unsecured creditors in a restructuring. Therefore, companies with second lien financings may find future restructurings more difficult. On the other hand, most second lien financings are completed with an understanding that a future restructuring is a possibility. Many of these loans are issued by institutional funds or hedge funds that are familiar with restructurings. In fact, some loans may have been issued with an expectation by the lender that a future restructuring will be required. Another complicating factor in a future restructuring is the inter-creditor rights between the first and second lien lenders. Therefore the combination of inter-creditor rights and the increased difficulty of obtaining DIP financing will make it more difficult for companies with second lien debt to restructure.

Pernick: Given a highly leveraged capital structure with secured debt, companies that have taken advantage of available...
capital in the form of second lien financing may be expected to face more difficulties in restructuring in the event of defaults, and that in turn may result in an increase in distressed M&A activity utilising the bankruptcy process. The emphasis in these types of cases may be on a controlled sale process given that secured lenders in these situations may be less willing to restructure these highly leveraged companies or to provide additional financing.

Patton: Compared with the restructuring of companies burdened with junk bond debt in the early 1990s, where a simple debt-for-equity swap was an obvious and easily implemented solution, companies with second-lien loans will be much more difficult to restructure. Valuation battles will hamper restructuring efforts and cram-down strategies will be harder to implement.

Glassman: The most important factor in achieving a successful restructuring is the strength of an enterprise rather than the capital structure. And no matter what the circumstance, the professionals are almost always able to reorganise the company if the underlying enterprise is healthy. In any restructuring there is only so much value to go around and it will need to be allocated based upon strict priority or compromise, or some combination thereof.

Schnelling: I don’t believe that second lien loans will make it harder to restructure – you just have to blow them away. What people often don’t understand with second lien loans is that they don’t get paid until the first lien is paid. If there is not enough money to pay the first lien they remain unpaid and are effectively unsecured.

Whether current investment strategies are the result of a lack of experience among hedge fund managers is not yet clear. One problem that seems to be evident is that some hedge fund managers follow the Gordon Gecko principle that greed is good. Another problem is that some managers believe they will be able to trade out of paper. Many hedge funds are manned by people who emerge from the trading environment, and bear an intuitive belief that one can always trade out at a price. There is a certain lack of understanding here, because if a restructuring reaches a certain point, no one gets to trade out. Some managers are deliberately ignoring this fact under the delusion that it will never happen. What we can say about hedge funds is that there are many more of them than there used to be and they are exposing their offerings to a much broader and less sophisticated part of the market investing public. In fairness to the people issuing $200m or $300m loans after three days of due diligence, there is so much money out there chasing dollars and chasing deals that it’s a bit like buying an apartment in New York: if you don’t pull the trigger quickly you won’t get it. It takes a lot of courage to hold back money in this market.

Sprayregen: Do you believe that defaults on loans, including second lien loans, will increase in the year 2006? Will such an increase lead to an explosion of new bankruptcy filings?

Loughlin: Yes I do. There has been too much debt layered onto companies whose business models and capital structures remain vulnerable to forces outside of their control. Competition (domestic and foreign) remains fierce, commodity prices are high and interest rates are on the rise. Higher leverage translates into a lower margin for error and less flexibility to deal with unanticipated events. Unexpected increases in operating costs, lower than anticipated sales or sales price and margin compression due to competitive pressures, will lead to more companies needing to restructure over the next 12-18 months.

Patton: Defaults on loans will increase during 2006. But unless the interest rate and currency markets change dramatically, the increase will be gradual rather than explosive.

Newman: Many companies that are currently over-levered and need to restructure have been able to avoid a restructuring because they have had access to incremental debt capital. This additional capital may have been used to extend debt maturities, make interest payments or fund cash flow shortfalls. In many cases, companies may have been able to use this additional financial flexibility to improve their operations and cash flow. As a result, some may have been able to “grow into” their capital structure and may never require a restructuring. However, many other companies may have simply “treaded water” or experienced further erosion in operations and cash flow. At some point, these companies will no longer be able to keep raising additional capital to extend maturities or fund cash flow deficits.

Pernick: I do expect that in 2006, there will be a significant increase in defaults due to the increased supply of capital chasing opportunities presenting greater and greater risk. In addition, many second lien lenders and many first lien lenders (hedge funds) have a different focus – meaning they often do not have a long term-view toward the credits and may likely be much more willing to allow borrower missteps to trigger a default. This is due to the tendency of the lenders in such situations looking to liquidate the underlying collateral

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so they can deploy their capital elsewhere. A large number of hedge fund lenders are currently cashing out of deals by requiring the borrowers to go out into the marketplace to raise expensive debt in order to take out the lender.

**Mayerson:** I do not believe we will see an explosion of new bankruptcy filings. However, with so many factors involved, including the rise in interest rates, oil prices and other economic drivers, it is likely that we will see an increase. In the long term I believe we will see an increasing trend of companies attempting to deal with these defaults outside of bankruptcy. But in the near term, due to the new bankruptcy law, it is likely that we will see an increase in filings within the next 180 days. This will allow those companies that are already on the ropes to avoid certain adverse changes to the laws which govern bankruptcies.

**Glassman:** The undeniable fact is that restructuring professionals have become more sophisticated and, in a favourable financing environment, many challenges can be overcome. The market has evolved to a point where there are usually a number of options, and we probably need Chapter 11 far less than we used to in light of the fact that even distressed assets can be sold almost in a heartbeat.

**Sprayregen:** What do you anticipate will be the effect of increasing interest rates and inflation on the rate of bankruptcy filings?

**Pernick:** Higher inflation and interest rates will surely contribute to an increase in corporate bankruptcy filings, but will not, by themselves, be the primary cause of increased bankruptcy filings. What is far from certain is the amount of time it will take for the effect of increased rates to make their way into the day-to-day economy. Marginal and highly leveraged companies and capital intensive industries will be primarily affected the earliest by interest rate increases.

**Mayerson:** As capital structures are very sensitive to interest rates, it is inevitable that if interest rates continue to rise, we will see a much sharper increase in the number of bankruptcy filings.

**Glassman:** How high interest rates will rise remains the common question and it is too early to say, although my feeling is we are closer to the peak than we are to the bottom. One sign that market activity is increasing is the fact that a number of law firms and financial advisory firms are once again hiring with the intention of building up their teams and capabilities.

**Schnelling:** The factors are the question. If rates turn up, the economy continues to be soft, people remain worried about growth, and inflation rises, we will see more bankruptcy filings. That’s a classic environment for bankruptcies. But it may not happen right away. Often you get a period where interest and inflation increase and people actually make a lot of money and it isn’t until something triggers the downturn that you start to get a lot of bankruptcy filings. Presently, interest rates are not rising fast and inflation is not roaring back, but the economy is overextended in the sense that many companies have too much debt on their books and they’re not making a lot of money.

**Newman:** Both short-term and long-term interest rates have been at historic lows for several years. Many companies have locked-in low fixed rates for a longer period (7-10 years). These companies will be relatively shielded in the near-term from an increase in interest rates. However, many companies have issued debt with even lower floating interest rates. As interest rates increase, those borrowers with floating rate debt will experience a more immediate increase in debt service costs. Depending on the rate of increase, this incremental cost to the borrower could be significant. Higher inflation contributes to increased interest rates. In addition, higher inflation is generally not good for the overall economy, the capital markets or credit markets. Therefore, inflation and higher interest rates will likely lead to an increase in corporate restructurings.

**Patton:** A continued decline in the strength of the dollar and a corresponding increase in the cost of imports may be a more significant negative force on import dependant companies that fail to implement effective currency hedge strategies. Inflation will dampen consumer spending leading to an increase in retail bankruptcies.

**Loughlin:** Rising costs, whether for debt capital or the essential components required to deliver a company’s goods or services, create pressure on earnings. Oil and gasoline prices are at record highs while many commodities such as aluminum and steel are at 10-year highs. At the same time it is nearly impossible to get price increases from customers in most industries. Wal-Mart, whose sales are approaching $300 billion, rarely accepts price increases and instead is focused on delivering lower prices to its customers by always seeking to buy more cheaply. The large automakers demand price decreases from their parts suppliers. Something has to give. When the credit markets tighten and access to capital is denied to struggling companies, there will clearly be more bankruptcy filings.
Sprayregen: Which industries will be hardest hit in upcoming years? Other than automotive, airline, and healthcare, are there any other industry sectors that you believe will see increased restructuring activity? What factors do you attribute to these problem areas?

Patton: Without a doubt the automotive and airline industries are going to be the hardest hit sectors in 2006 and 2007. Additionally, the continued evolution of wireless technologies will trigger a second wave of telecom bankruptcies, and continued fragmentation of media sources will cause continued revenue declines for a number of media properties and continued consolidation and solvency problems in the media sector.

Loughlin: I have been amazed by the strength of the real estate market; prices for homes, apartments and commercial real estate have continued to rise. Recently I ran into a friend who told me he tries to buy at least 3 or 4 speculative homes in Florida each year. The ploy is to “flip them” for a significant profit before the construction is completed in 6-9 months. The market is super-heated and I expect a significant correction. This could lead to problems in the home building, lumber, building supply and mortgage industries. Basic US manufacturing companies also continue to deal with pricing pressures from competitors who have outsourced to China and other low labor cost Asian countries at a time when commodity prices are extremely expensive.

Glassman: Every asset has its lifecycle. For example, refineries are now very attractive properties, but I wouldn’t be surprised to see the refining industry encounter problems over the longer term as we move away from using gasoline as fuel for transport vehicles – especially when the hybrid vehicles start performing better than the non-hybrid. And that’s already happening.

In the near term, another industry that will continue to reach headlines is the healthcare sector. Currently there are a number in the pipeline, but it remains one of those industries where banks are willing to lend. In most cases these loans have been based on enterprise value rather than asset value, and banks do not appear willing to see these companies file Chapter 11. The long-term result is that these bridge-loans are not benefiting the enterprise at all, not in a heavily regulated industry that has a number of flaws. I feel they may be simply delaying the inevitable. I see the insurance industry as another that will continue to face difficulties through greater regulatory scrutiny leading to greater loss recognition. This will result in reduced profitability, at least on paper. In an industry with such large reserve requirements, this is going to severely cramp cash flow.

Newman: In addition to the airline and automotive industries, any industry with a significant dependence on raw materials may be more likely to require a restructuring. In recent years, prices of most major raw materials, including oil, natural gas, coal, steel, have increased significantly. These price increases have resulted, in part, by the dramatic economic growth in countries like China and India. This increase in economic activity and corresponding increase in demand for such natural resources have led to worldwide increases in raw material prices that are not likely to decline in the near term. Any industry that has a significant amount of its costs based on such raw materials is likely to be adversely impacted. In addition, any industry or company that has a mature work force or large retiree pool is also more likely to require a restructuring. This is due to the dramatic increase in recent years (and expected continuance) of health care costs.

Pernick: Manufacturing, particularly those reliant on oil and natural gas, will be especially affected by these expected trends. In addition, the retail sector may be vulnerable as consumers continue to be squeezed by rising energy costs and inflation concerns. Commercial real estate enterprises that still rely on borrowed funds may also experience a downturn.

Mayerson: The manufacturing sector is one which certainly faces a number of challenges in the current climate. For today’s businesses, many face the threat of foreign competition, volatility in international economies, currencies and other factors that can affect productivity and operating costs such as the effect of ever-increasing technology. For those companies that rely heavily on the Chinese economy, the value of the Chinese Yuan and the uncertainty over this currency’s future may have serious repercussions on US manufacturing and textile businesses. Also, with the constant rise in labour and pension costs, many traditional manufacturing and rustbelt companies may find themselves seeking Chapter 11 protection as a way of dealing with their pension and healthcare liabilities.

Sprayregen: What is the future of the airline industry? How will the increasing price of oil impact the airlines and other industries?

Schnelling: The airline industry is a fundamentally sick industry. Its problems all emerge from the fact that it was once profitable, and during these buoyant years it undertook massive amounts of pension obligations to its workforce. It now has a large overhang of those obligations. It is also burdened by the fact that at least a good part of the model requires mul-

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multiple aircraft usage by each line. In addition, very few airline companies are hedging fuel prices, or were able to finance such hedges.

There was an article a couple of months ago regarding talks between the French, German, English and US governments representing Boeing on the one side and Airbus on the other, suggesting that people were finally getting together to discuss ending government support through direct and indirect subsidies to aircraft manufacturers. Frankly, that is the problem. As long as Boeing and Airbus can finance and sell infinite numbers of aircraft to companies that have a desire to be in the airline industry or an entrepreneur has the money required to start up his own company, companies will not have serious maintenance headaches for five years, they will not have the crewing issues of the legacy carriers if they use single-style aircraft, so they will be able to offer flights at a very low rate. Pricing at the margin actually drives pricing through the system. Therefore one airline owner can ruin the industry for everyone else. We see that frequently, particular because, on top of other problems — such as easy acquisition of aircraft and complex crewing and manning structures — old line airlines have a legacy pension system that puts a great part of its manageable cost on labour. This creates a great deal of animosity as labour is forever being asked to give back money. One flight attendant recently joked to me that she understood that those employees who stay are those who love to fly but worry about eventually having to pay the airlines for the privilege of working there. Airline companies are taking more out and the unions are rightly upset but the truth of the matter is that there is not much else to take. It’s not a pleasant situation.

Newman: While September 11 and significant increases in oil prices have forced several major carriers into Chapter 11 or to pursue a debt restructuring, I believe the airline industry has a more fundamental problem. Specifically, the major airlines have cost structures that preclude them from being competitive in a very competitive industry. Many of the low cost carriers have been able to operate successfully while charging fares at a fraction of the major carriers. I believe that these companies have recognised that for most travellers, an airline seat is a commodity and most customers want the cheapest alternative. As a result, these carriers established a cost structure appropriate for a highly competitive industry. The major carriers have not been able to do this, largely due to significant power wielded by labour unions.

Loughlin: The combination of high fuel costs and low fare competition from more efficient discount airlines like Jet Blue and Southwest continues to hit the majors pretty hard. If oil prices stay at current levels or continue to rise, it is hard to see how there will not be more airline bankruptcies. There needs to be a fundamental restructuring of the industry as a whole as the legacy cost structures of the majors are no longer viable relative to the discount carriers who continue to grow and steal market share. However, anytime an industry has to undergo such overwhelming change, it does not happen voluntarily. I think you will continue to see a slow decline of the majors unless they are able to totally change their business models and cost structures to allow them to remain viable. Some simply do not have the financial strength to do this without a Chapter 11 filing.

Mayerson: The airline industry is one that is facing a complete transformation of its business model, involving a shift to a low-cost carrier service. I believe that with this shift we will see an undeniable move towards further consolidation and industry-wide reform. As a result of this change, the ultimate outcome will be a more operational and financially streamlined industry offering one clearly defined, cost-based rather than service-based travel solution. Although this will leave room for one or two luxury carriers, I do believe that the low-cost carrier model will emerge to be the dominant force in the airline industry.

Pernick: The future of the airline industry, and particularly the legacy carriers, remains a concern given the carriers’ historically high fixed costs in the form of labour and related costs and oil. There may be a need to have additional government intervention if the administration’s policy is to keep competition among the various carriers. I believe we can expect further shakeouts, from both failures and mergers, resulting in additional consolidation. The survivors who make it through this turbulent process, who generally have historically lower cost structures, should face less competition and enjoy greater profitability. The rising and uncertain cost of oil will continue to hamper the recovery of the airline industry and will continue to pressure those industries that are highly reliant on the use of oil – such as the transportation industry.

Glassman: The airline industry, in my opinion, is comprised of natural monopolies and should never have been deregulated. It is likely that this sector is going to continue to suffer in large measure until consolidation reestablishes the natural monopolies. Also, technological change (such as increased use of video conferencing) will impact utilisation as air travel becomes less essential to international business. The next two to five years will see some drastic changes.

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Patton: The airline industry will continue to struggle with a changing business paradigm. The separation between short-haul routes and long haul routes among regional and national carriers will continue during the coming years, and the hub and spoke model employed by the large carriers will curtail profits. The corresponding challenge for established carriers will lead to serial bankruptcy filings as the established carriers struggle with legacy costs and irrational business models. Fuel prices will only exacerbate these problems.

Sprayregen: What impact do you believe the proposed Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 will have on bankruptcy filings in the United States?

Mayerson: A number of provisions will damage the very fabric of the bankruptcy process. The first and most insidious of the provisions is the rule forcing attorneys to certify the financials upon due inquiry. In light of the various accounting methods used by many companies, for example, using compilations as opposed to audited reports, it is difficult for practitioners to identify fraud. This places an onerous risk on the attorneys, and the extent to which these liabilities will affect them personally is not yet clear. Another of the most significant changes to be introduced is the rule that the exclusivity period cannot be extended past 18 months for any reason whatsoever, which in my view will remove all incentives for parties to work towards a common goal and makes it extremely difficult to achieve results in a timely fashion.

Glassman: Another significant change is that this legislation makes it a lot harder to get successive extensions of the deadline by which one must elect to assume or reject leases. In the case of real estate leases, this places unrealistic time demands on the organisation leaving much power and control in the hands of landlords. This change, together with the expanded limitation of exclusivity could create an imbalance of power between various special interest groups and remove the flexibility of the courts.

Newman: The 18-month limit on debtor exclusivity (20 months for vote solicitation) will create many more situations where courts will have to entertain competing plans of reorganisation, leading to protracted litigation. Further, the new law provides significant restrictions of payments to senior officers relating to retention and severance. These restrictions will severely hinder the ability of financially troubled companies to recruit senior executives. Even recruiting before a potential Chapter 11 filing will be hampered because a Bankruptcy Court may not be able to approve the assumption of an officer’s employment agreement which contains such standard provisions as a two-year severance payment because it is more than ten times the average severance for the entire work force (the new standard).

Patton: The enactment of the Act will likely cause a short-term increase in filings, particularly in the retail sector where retailers will have a significant advantage if they file bankruptcies before the effective date of the new Act.

Pernick: The new bankruptcy Act, signed into law on April 20, may well lead to a short-term increase in consumer bankruptcy filings to take advantage of the perceived more lenient provisions of the existing Bankruptcy Code – particularly Chapter 7. Thereafter, consumer bankruptcy filings will likely decrease for some period of time and then level off in the long run to levels similar to those experienced in the past few years, as consumers and debt counselling professionals grow accustomed to the new rules and conditions for consumer debt relief. In addition, the press has tended to cover what I believe are isolated cases of abuse. While there will be some long term increase in Chapter 13 filings by those who have some limited ability to repay a portion of their debt, I do not expect a massive sea change in the overall long term numbers of debtors filing Chapter 7 and Chapter 11 cases. On the corporate side, there may be certain companies that could gain an advantage from filing prior to the effective date of the new Act provisions, specifically those companies with significant commercial leases such as retail chains, because of the shortened time period to allow such companies to decide whether to maintain or dispose of their commercial leases under the new Act. Also, the imposition of an absolute deadline of 18 months for the exclusive period for companies to propose a Chapter 11 plan may cause companies that need substantial restructuring within a bankruptcy to file prior to the effective date of the new Act. The effective date for the new Act generally, subject to exceptions for a number of particular provisions, will be October 17, 2005.

Schnelling: The Act will cause many companies to file almost immediately in order to escape – to the extent they can – the effective date of some of the provisions. There are a lot of elements of the new act that are controversial – but many have received a negative reaction simply because they are different. Speeding up the process is not necessarily bad;
what is a problem is that many of these changes are draconian in the sense that they place demands on companies and judges to follow processes without exception. Judges have now been given absolute deadlines, where under the Code they had flexibility to adjust timing in a case based on facts presented.

The drafters appear to have wanted to eliminate flexibility and they ensured that it was not given. But this is not necessarily a bad thing. Companies that have a very significant real estate component really should be looking at this aspect of their operation sooner rather than later. Any good lawyer will defer a decision as long as that lawyer can, assuming there is no harm to their client. Businessmen on the other hand need to consider what is going on in the company and decide whether or not it is an advantage or a disadvantage to delay a decision. Oftentimes when a company is in crisis, delaying decisions is not as beneficial as acting on them. Driving managers to focus on critical aspects of the business earlier is not necessarily a bad result of the new law.

Loughlin: Consumer bankruptcy experts are predicting that there will be massive increases in personal bankruptcy filings in the next six months to preempt the provisions of the new law which will take effect six months after the President signed it. I do not expect this to have much of an impact to our business, as we do not deal with consumer bankruptcies.

Sprayregen: Is there a trend towards more pre-negotiated plans and out-of-court work-outs?

Pernick: Over the last few years, there appears to be a higher frequency of pre-negotiated restructurings. I believe that this trend may continue, particularly given the new bankruptcy Act provisions regarding an absolute deadline for plan exclusivity. This provision may lead to earlier negotiation and development of restructuring plans prior to the commencement of the bankruptcy case.

Patton: Under the new Act, debtors who can proceed quickly through bankruptcy are significantly advantaged.

Glassman: The shift towards pre-negotiated plans and out-of-court workouts is largely due to the fact that the entire market place is becoming more efficient. Chapter 11 is not cost effective, and in many cases the various constituencies will seek a settlement away from the public eye. As professionals and creditors become more sophisticated, and with the increasing participation of hedge funds, it is more and more likely that the core parties will remain focused on reaching a deal that suits them in a timely and efficient manner.

Loughlin: With the size of the corporations filing for Chapter 11 getting smaller (in comparison to some very large company filings in the 2001 to 2003 timeframe), it makes sense to work through as many issues as possible on a pre-negotiated or pre-arranged basis. The increased liquidity in the credit markets over the past couple of years has also made it a little easier for distressed companies to negotiate workouts without a filing as financing alternatives for troubled companies are available. I think companies and their stakeholders should always attempt to work though issues out-of-court or on a pre-negotiated basis where possible but this may become more difficult if credit markets tighten in the future. The Chapter 11 process is clearly very expensive and, from my perspective, should always be used as a last resort.

Newman: Given the limitation on exclusivity in the new law I believe there will be an increase in pre-negotiated deals. Although we will always see some level of exchange offers (out-of-court), I don’t believe the rate will accelerate.

Mayerson: To date, the US bankruptcy process has been designed to manage the process towards consensus, and now with new legislation favouring different special interest groups, that goal will be increasingly harder to achieve. I feel that these new provisions will work against achieving consensus and force many practitioners to seek out-of-court agreements.

Schnelling: I don’t think there is or will be a significant uptick in the use of pre-negotiated plans or out-of-court work-outs. A pre-negotiated plan is perfect if you can get all the constituents on board, but the essence of the whole insolvency process is that it is difficult to encourage people to agree.

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