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Published by Financier Worldwide Ltd

ROUNDTABLE September 2020

BANKRUPTCY LITIGATION

The onset of COVID-19 has led to disputes between companies whose revenues have been severely affected and creditors who, in many cases, have gone unpaid. Although governmental interventions, such as restrictions on winding up petitions, have had an obvious and profound effect on the debtor and creditor relationship, such measures are generally short term. And with no substantial relief from the pandemic in sight, many anticipate a steady volume of corporate distress and bankruptcy filings, as well as extensive legal action, in the months to come. ■

THE PANELLISTS

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Colin Ashford is a partner in Brown Rudnick's bankruptcy and corporate restructuring team. He is a highly experienced and well-regarded insolvency and restructuring lawyer, with a particular focus on contentious issues and investigations. Using that knowledge and experience, he also advises on contingency planning exercises to 'insolvency proof' deal structures, and generally advises boards to protect directors from challenge or criticism. He has worked on a number of the largest insolvencies in the UK.

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Van C. Durrer II regularly represents public and private companies, major secured creditors, official and unofficial committees of unsecured creditors, investors and asset-purchasers in troubled company M&A, financings and restructuring transactions, including out-of-court workouts and formal insolvency proceedings.

FW: Reflecting on recent months, what do you consider to be the most significant trends and developments affecting bankruptcy litigation? Given the economic outlook, what are your expectations for a rise in corporate distress and bankruptcy filings?

Montgomery: In recent months, the UK has implemented corporate insolvency reforms, including a new restructuring plan. This is similar to a scheme of arrangement but allows cross-class cram down. Dissenting classes can be bound, despite voting against the plan, if they are no worse off than in the relevant alternative. This raises the prospect of disputes around what the relevant alternative is and around valuation of claims and insolvency outcomes in that scenario. Coronavirus (COVID-19) has also led to disputes between companies whose revenues have been severely affected and landlords and other creditors, who in many cases have gone unpaid. Government interventions have suspended winding up petitions in such circumstances, but those restrictions are due to be lifted at the end of September 2020.

Durrer: In the US, we are seeing increasing instances of official committees of unsecured creditors seeking 'standing' to pursue causes of action on behalf of Chapter 11 debtors. Specifically, this is where an official committee seeks permission to assert claims against senior creditors or against a debtor's board of directors to challenge claims or liens – in the case of senior creditors – or otherwise assert breaches of fiduciary duties, in the case of directors. One explanation for this increase is there are precious few assets from which unsecured creditors can otherwise recover, after the satisfaction of senior secured creditors. We do anticipate a steady volume of corporate distress and bankruptcy filings in coming months, as there appears to be no relief from the pandemic in sight. This economic downturn does appear to be more of a 'main street' event, however, than the 'Wall Street' downturn of 2008 following the collapse of Lehman Brothers.

Boynton: In the short term, the restrictions on the presentation of winding up petitions against companies affected by COVID-19 has had an obvious and profound effect upon the relationship between companies and their creditors, landlords in particular. From a longer-term perspective, the passing of the UK Corporate Insolvency and Governance Act 2020 (CIGA) is obviously a highly significant step for our industry. The new restructuring plan and, in particular, the ability of companies to effectuate cross-class cram downs, is a major development. We have already seen Virgin Atlantic Airways launch such a plan; its creditor meetings and the court sanction hearing are scheduled to take place at the end of August. We think it inevitable that there will be increased litigation as courts consider issues such as which stakeholders should vote on a plan, class constitution, the new 'cross-class cram-down' provisions and related concepts, and whether the plan is 'just and equitable', given the significant degree of discretion afforded to courts. As well as new legislation, notable trends include potential claims arising out of the effect of material adverse change and event of default clauses, as well as the use of baskets to transfer assets outside the security perimeter, often in order to facilitate raising new indebtedness secured by those assets.

Ashford: There will be an increase, probably a substantial one, in distress and bankruptcy filings. In the UK, there has been a certain amount of 'kicking the can down the road', through various loan schemes, employee furloughs, deferral of rent, non-payment of taxes and rates and so on. While this has been necessary for very many businesses, the reality is that they are straddled with huge liabilities and no obvious way of being able to repay. As we start to unwind the lockdown and moratoria, that is when we will see an increase in filings. It has happened in the US already, where the volume of Chapter 11 filings has taken off, whereas in the UK the statistics show a very low number of filings, despite several household names disappearing from the high street. The most likely scenario is a large increase in the number of company voluntary arrangements (CVAs) – a debtor-in-possession (DIP) process aimed at compromising liabilities.

FW: To what extent are creditors and other stakeholders taking a more creative and consensual approach to finding workable solutions for struggling debtors?

Durrer: Particularly in the retail space, we are seeing innovation in Chapter 11 filings. Many distressed retailers are looking to decrease their brick and mortar footprint, but liquidation sales are all but impossible due to prevalent 'stay at home' orders imposed by federal and local authorities during the pandemic. As a consequence, creditors, debtors and courts have developed 'freeze' orders and related relief, where Chapter 11 retail cases are essentially put on 'pause' for a time until retail goods can be liquidated or other solutions are negotiated. In addition, we have seen prepackaged cases for Chapter 11 retailers and other debtors as stakeholders in some situations seem to come to a consensual solution more quickly in the face of the pandemic.

Boynton: Many creditors have been pragmatic and open to providing debtors with ample time to find workable solutions, particularly where the debtor's shareholders have agreed to contribute additional capital. However, others have been more reluctant to compromise, especially where there is evidence that the business was struggling even pre-COVID-19, making liquidity solutions more challenging to obtain. As ever, much depends on the leverage each stakeholder has during the negotiations and what the alternatives to a compromise are for each actor. Each situation is unique, and the market is continually innovating creative solutions.

Ashford: There has been a very altruistic approach taken by most stakeholders so far – after all, the current crisis is affecting everyone and is not perceived to be anyone's 'fault' unlike, perhaps, the 2008 banking crisis. This approach has manifested itself mainly by way of debt deferral rather than forgiveness. But for how long can this last? At what point will businesses have to start looking after themselves and their own stakeholders, including shareholders, and demand payment for goods supplied, services rendered, or rent accruing? In the UK, there have been many companies struggling for several years, kept afloat by low interest rates. The task going forward will be to distinguish between those companies and the ones that have genuinely been hit by, and only by, the COVID-19 pandemic.

Montgomery: The COVID-19 crisis has led to many usually-profitable businesses struggling to pay creditors, due to dried-up revenues and limited prospects for short-term recovery. Where there is clear underlying value, and in the case of regulated financial institutions, prompted by regulators and supported by government, creditors have shown willingness to forbear. Until it is clearer what the end state is, longer-term restructuring has not generally been possible, though attention is turning to liabilities that have built up during this period and may prove too great for the balance sheet to bear, even with a strong 2021 recovery. This is especially true for small and medium-sized enterprises, which cannot be expected to afford the traditional mechanisms of restructuring.

FW: Are mediators and arbitrators playing a more active role in the bankruptcy process? What are the pros and cons involved?

Boynton: We have not seen any material uptick in the use of arbitration or mediation in the UK restructuring and insolvency market, perhaps because these are consensual processes and recent market conditions do not make it any easier to reach a consensus. Arbitration does not, of course, provide companies with the range of tools available to them if they applied to court. There is rarely a dispute about a debt which would make sense to solve via arbitration in a fast-moving insolvency scenario. We can see how mediators could be useful in the right cases.

Montgomery: The interplay between arbitration and insolvency has been area of recent focus, though the practical effect of it is, at least in my experience, yet to be seen. It is something we may see develop in coming months, as the COVID-19 downturn really starts to bite. If an officeholder is comfortable with the process, there is no reason in principle not to use mediation or arbitration in the insolvency context, as a potentially cheaper way of resolving a disputed proof or an outwards claim. They will want to be confident on the level of costs risk though. While not directly on point, the recent UK Supreme Court decision in *Bresco v Lonsdale*, which held that the English construction adjudication regime can be used by liquidators and is compatible with the operation of insolvency set-off, provides some encouragement in this regard.

Durrer: Mediation remains a valuable tool to drive consensus in Chapter 11 cases. However, during the pandemic, the dynamic of mediations has changed significantly. For example, it is no longer possible to require principals of stakeholders to commit a day or days to be physically present in a set of conference rooms with the principals of other stakeholders, compelled by a mediator physically present to reach a deal. As a consequence, there is less of the natural kinetic energy that a physical mediation would otherwise generate. Mediators need to work harder and be more proactive to counterbalance this shifting paradigm. Mediators who are former judges seem to have more gravitas to compel thoughtful participation in mediation during the pandemic.

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FW: How would you characterise the evolving dynamic between various creditor committees and creditor classes throughout a bankruptcy process? What impact is this dynamic having on bankruptcy litigation?

Montgomery: The restructuring plan potentially allows for creative uses that were not previously possible with a scheme, such as possible a ‘cram-up’ restructuring, forced through with the votes of junior classes of creditors. The UK legislation has no equivalent to the absolute priority rule in US Chapter 11, leading to speculation that this may be possible in appropriate cases. A new ban on ipso facto termination of supply contracts in UK insolvencies has also changed the dynamic between debtor companies and would-be ransom suppliers. There is potential for dispute around an exception for financial hardship, which remains to be tested, and if suppliers attempt to use other grounds to terminate early, in anticipation of insolvency.

Durrer: One criticism that is often levelled against Chapter 11 restructurings is the expense. For example, the Chapter 11 debtor must bear the professional fees – legal and financial – of most other stakeholders, including multiple layers of secured creditor classes, as well as the official committee of unsecured creditors. With respect to secured creditors, there is also frustration because the collateral of such creditors is effectively utilised to pay the expenses of creditors that sit behind them in terms of rank and priority. Thus, there is a bit of a perverse incentive for junior classes of creditors to pursue litigation to increase expense, and therefore create leverage to force senior creditors to agree to share more value with junior classes rather than face value destruction through a prolonged legal battle.

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Ashford: Committees and creditor classes have not really been an issue in the UK process to date – we have a well-recognised and respected model where primacy is generally given to the rights of secured creditors. Everyone 'knows their place'. But the CIGA which came into force on 26 June 2020 may well throw all that out of the window. For example, there is scope for a prohibition on enforcing security once a company enters a moratorium process. Certain debts accruing due could, in some situations, rank ahead of that security. And there are continued plans to revise the preferential status of certain Crown debts. It is too early to say how this will play out, but the dynamics between the secured and unsecured classes will certainly change. In addition, while classes of creditors were relevant for schemes of arrangement, one class could not impact on a dissenting class. That has all changed, as it will now be possible to bind dissenting classes. So the categorisation of creditors, and where the value breaks in a restructuring, will perhaps be more important than ever.

Boynton: In contrast to US Chapter 11 cases, there is no official creditor committee in an English scheme of arrangement, restructuring plan or CVA, which are the most likely tools for implementing a restructuring in this jurisdiction. There is the possibility of, but no requirement for, an official creditor committee within administration, administrative receivership, certain types of liquidation and personal bankruptcy, but such committees play a fairly limited role. However, informal creditor committees are often hugely instrumental in the negotiation and implementation of restructuring deals. Such committees continue to be an effective way for creditors to ensure that their voices are heard when structuring the transaction and then as a mechanism to garner broader consensus for the proposed compromise. Such committees are usually formed on an ad hoc basis. There have been a number of recent judgments which reiterate the need to ensure that the deal for creditors which are not part of the committee remains fair – such as the option of participating in a new money facility – and that such creditors are given sufficient time to consider the proposal negotiated by the company with the ad hoc committee and other stakeholders more involved in the process.

FW: Not everyone can emerge satisfied from a bankruptcy dispute. In your experience, what factors are required to reach a positive resolution for the benefit of most interested parties?

Durrer: The three key factors that assist any complex restructuring are transparency, a realistic assessment of the situation and creativity. Transparency is an essential platform where all stakeholders are operating with the same basic set of facts. It also enables parties to believe that they are being heard and understood, which is important for any negotiation, however contentious. Realism is likewise important. What is the value of the company as a going concern? What drives that value? Who are the right managers to carry the business forward? What are the relative strengths and weaknesses of the parties' litigation positions? Finally, Chapter 11 is a tool that is malleable to creativity. It is something of a blank slate on which the parties can craft a variety of solutions to both balance sheet and operational troubles.

Ashford: Openness and integrity are vital. Certainly, no one is satisfied in an insolvency – by definition, there is not enough money to go around and people always want to blame someone. If parties feel that they properly understand the situation, then they feel better equipped and enabled to accept the outcome. Take the so called 'pre-pack' administration, for example. The primary objective is to try and have a seamless transfer of trade, thereby preserving jobs and value. But of course, it looks as if the old creditors have simply been left behind and a new business started, and so creditors feel aggrieved. That is because no one really knows about it until it has all happened. There are now better guidelines for informing creditors about this – more detail, more quickly – which has helped to assuage creditors that, sometimes, this is the right thing to do for the creditors' benefit.

Boynton: Whenever a dispute is resolved consensually, it is almost inevitable that one or all parties feels hard done by. The trick is to ensure that everyone is equally unsatisfied with the outcome. Bankruptcy disputes are no different. However, it is important to ensure that the rationale of any outcome is explained to creditors so that they understand how different rights have been treated and why. All creditors can and should expect pari passu claims to be treated equally. That said, the fact remains that those that do best out of a bankruptcy dispute are those that have organised most effectively and, most importantly, those that have the most leverage in the discussions, be that because they are in a structurally or contractually superior position or because of the commercial dynamics at play in the negotiations. COVID-19 has not, in our experience, affected the reality that those in the strongest position can to a very large part drive a resolution and, provided they respect whatever rights subordinated creditors have, can expect to conclude a deal with which they are happy.

Montgomery: Though there will generally be a settlement that can be achieved to avoid the irrecoverable costs of litigation, insolvency litigation is generally less likely to settle than other types of dispute. There is a finite pot of assets and often no ongoing business, so the outcome is sum zero and the incentives to settle are fewer. Litigation is an increasing feature of restructuring processes though, as seen for example in the challenges to CVAs over the last couple of years. The support of majority senior creditors is essential to see off opportunistic challenges from disgruntled minorities, who may not be rational economic actors, but rather pursuing some ancillary interest in disrupting the process.

FW: To what extent do you expect to see directors & officers specifically targeted by creditors in bankruptcy-related litigation?

Montgomery: It is something we see increasingly in England, driven by the availability of directors and officers (D&O) insurance. Claimant law firms are formulating increasingly sophisticated causes of action against boards of directors where there is significant insurance coverage. In circumstances where that is the only pot of cash potentially available, stakeholders will try to figure out a way to get at it. In England, we would usually expect those claims to be brought by insolvency officeholders or their assignees, rather than directly by creditors, but there is an ongoing trend for some creditors to seek leverage through bringing claims that are largely speculative. Each situation will be different, but in some circumstances, it is possible insurers will seek to settle rather than continue to incur defence costs, even where the directors insist the claim is baseless and want to fight all the way. A large claim or investigation will in many cases exhaust the primary layer of insurance, before the question of damages or fines even comes to be considered, so the leverage can certainly exist, and the availability of specialist litigation funding is an additional feature.

Boynton: In the short term, we expect the targeting of D&Os by creditors to be limited, given the adjustments to the wrongful trading provisions and the effect that will have upon the ability of insolvency practitioners to bring such claims. However, on a medium term basis, we may see an increase in such claims following cases like Lehman Brothers Australia and the fact that D&Os will have been taking significant decisions about their businesses with almost no visibility or certainty as to future earnings and cash flows. If these projections turn out to be wrong, and the COVID-19 effect is more profound than estimated, we could see disenfranchised creditors viewing D&O cover as their only realistic route to recovery.

Ashford: It is difficult for creditors to establish a direct cause of action against the directors. More often any claims are brought by the insolvency practitioner appointed to deal with the business and indeed they have more tools and claims available to them. That said, recently changes to the law allow many insolvency related claims to be assigned – and so we are seeing instances of disgruntled creditors seeking assignments of claims from the insolvency office holders to pursue for their own benefit. Query, however, the financial worth of many directors which makes a substantial recovery unlikely. In current times, we expect there will likely be fewer successful claims against directors – no one envies the extremely difficult position boards find themselves in

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and a court will be slow to suggest that an alternative course was the better route.

Durrer: Due to the economic downturn caused in large part by the continuing pandemic, distressed companies are suffering real blows to their valuations, so there is less economics available for junior creditors. Those junior creditors' fiduciaries will naturally look to create or influence alternative sources of value for their constituency. Unfortunately, this includes attempts to access D&O insurance policies by crafting allegations to state claims for breach of fiduciary duties. In the modern age of casual written communication through email and text, there are quite a few opportunities to make mischief out of communications that are taken out of context in order to promote a storyline of culpability that may survive a motion to dismiss. D&Os are well served to be vigilant in their communication protocols.

FW: What are your predictions for the bankruptcy litigation arena over the coming months and years? What types of disputes do you expect to be prevalent?

Boynton: The implementation of Brexit – scheduled for 31 December 2020 – will likely have an effect on the portability of English insolvency litigation and resulting judgments. The extent to which English court rulings are still able to be exported to the rest of Europe is open for debate, and fact-specific; this recognition is especially relevant for European companies considering an English scheme of arrangement or restructuring plan. This may be the subject of litigation unless clear political agreements are reached – which appears unlikely in the limited time remaining.

Ashford: There will be the inevitable 'blame game' litigation – those who argue that they should have been lent more money or less money or given more time to pay. And corporate lending memory is short – so we have seen a raft of covenant-lite lending over the past few years, but with property prices crashing and many businesses struggling, there will again be intercreditor disputes about the intended terms of transaction. Perhaps the biggest growth area will be around the new cram-down process brought into force in June. Who is in or out of the money? What are the alternatives that the court should be taking into consideration? What counterfactual valuations are there? These are all areas which will be litigated. And the new moratorium also provides unwelcome opportunities for litigation. What is the role of the monitor? What is the consequence of the moratorium being continued for too long or not long enough? There will be disgruntled directors, shareholders and lenders who will be looking to go on the offensive.

Durrer: As the pandemic continues to impair recoveries of junior classes of creditors, we expect to see a rise in bankruptcy litigation. We will see an increase in breach of fiduciary duty litigation against D&Os. We likewise expect more attacks on the propriety of liens in favour of, and transactions with, senior secured creditors. In order to address this, companies will, and should, put an increased reliance on the use of independent directors and related advisers. However, in order for this approach to be successful, companies should be very precise in how they select, appoint and empower such independent fiduciaries.

Montgomery: The parameters of the restructuring plan will be developed through case law, particularly the extent to which cross-class cram down can be achieved. Where a scheme of arrangement would work, debtors will continue to use that tried and tested process, so the first contentious plan cases will be the difficult situations which test the boundaries of what can be achieved. Much will depend on the underlying commercial merits of the proposal and which judges hear the crucial first few cases. It will also be interesting to see how the court's respond to the expected wave of enforcement activity, once the current temporary restrictions are lifted. The end of the Brexit transition period this year will doubtless lead to increased focus and disputes in 2021 around cross-border recognition of insolvency and restructuring processes. ■

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