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Bankruptcy's Impact on Financial Markets

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The idea for this topic began with conversations between one of the co-authors and a prominent bankruptcy attorney. That attorney believed that changes in the capital markets over the last few decades had significantly impacted bankruptcy practice, but that bankruptcy was of only minor significance to the capital markets. His view was that in the broader economy, so few deals actually default that default remedies, including bankruptcy, are little more than an afterthought to market participants. This view is not uncommon among financial market participants. After all, particularly in boom times, the primary focus of the capital markets is making deals happen. In fact, changes in the financial markets, for example, the development of loan-to-own strategies and claims trading, have certainly altered the outcome of reorganization cases and the rights and remedies available to debtors and creditors alike. However, while it is certainly true that changes in the financial markets have had a great impact on bankruptcy practice, it is also true that changes in bankruptcy practice have had enormous impact on the financial markets and on the economy.

Evidence of Bankruptcy's Effect on Financial Markets

To truly appreciate the impact of bankruptcy on the financial markets, one need look no further than the everyday behavior of lenders and other financial markets participants as they go about their business. Lending documents,

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often hundreds of pages in length, include extensive and detailed sections dealing with the possibility of default. These provisions are so extensive that they reflect a great concern about how the loan will be col-

lected in the event of default. Certainly, these provisions would be far narrower if concerns about default remedies were not paramount.



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debt markets have of the effects of bankruptcy. Article 9 of the Uniform Commercial Code was recently revised to provide additional protections for secured creditors vis-a-vis bankruptcy trustees. Under

§ 544, of the Bankruptcy Code the bankruptcy trustee has the rights and powers of a judgment lien creditor under certain circumstances. Prior to the passage of the revised Article 9, a judgment-lien creditor had priority over a secured creditor who filed a financing statement but did not have possession of an instrument, and therefore the priority of secured creditors was limited. Under revised Article 9, such a secured creditor would have priority over a judgment-lien creditor,

On the Edge

Additionally, billions of dollars are expended annually because of lenders' requirements that special-purpose vehicles (SPVs, also known as special purpose entities or bankruptcy-remote entities) be established as part of securitization transactions. These SPVs' primary purpose is to avoid the impact of bankruptcy laws upon default, and in particular, to avoid the automatic stay. Companies are encouraged to set up such vehicles by the prospect of a lower interest rate from potential lenders, who view the SPVs as a safety net that protects their loans from the impact of bankruptcy. These additional expenditures, enormous in the aggregate, would not be undertaken if people were not concerned about the impact of bankruptcy.

Other developments also reflect the keen awareness participants in the

and thereby priority over a bankruptcy trustee. This revision, among others, has diminished the trustee's strong-arm powers and enhanced the priority enjoyed by secured creditors. The drafters of Article 9 would not have been inclined to make these changes were they not concerned about the rights of secured creditors vis-a-vis bankruptcy trustees.

Finally, there are those capital market participants that acknowledge the importance of bankruptcy administration to their business. At a 2007 ABI seminar, Ward Mooney, CEO of the commercial finance company Crystal Financial, indicated that certainty as to the ability and methodology of disposal of collateral in a chapter 11 proceeding was a critical factor affecting the growth of second-tier lending. Mooney was his usual percep-

tive self. Understandably, if lenders are confident in their ability to realize upon their collateral at close to going-concern values in a predictable timeframe, they will be more willing to make second-tier loans to companies.¹

Changes in bankruptcy practice have created a sense of certainty as to the realization of collateral, and therefore encouraged lenders to more confidently rely on such collateral in extending second-tier loans. As certainty has increased, lenders have been encouraged to lend deeper and deeper into the balance sheet, resulting in more and more debt, higher advance rates, and the leveraging up of companies. Certainly, prior to the advent of the Great Recession (and even today to a great extent), the right side of balance sheets was likely to contain far greater debt in the capital structure at levels that would, in earlier times, have been supplied by equity investment.

Some of Changes in Practice that Have Altered Financial Market Landscape

It seems obvious that recent amendments to the Code, such as BAPCPA, have made life more difficult for debtors, particularly retailers. The changes that have had the greatest significance to the financial markets and the economy began long before these recent changes, and that the recent changes are a mere continuation of longstanding trends.

Prior to the passage of the Bankruptcy Reform Act of 1978 (the Bankruptcy Code), parties had the right to restructure under chapter X or chapter XI of the Bankruptcy Act. Chapter XI was very debtor-oriented, and chapter X was very creditor-oriented. Chapter X required the appointment of a trustee at the commencement of a case, provided no exclusivity rights for debtors, and any chapter X plan was required to strictly follow the absolute-priority rule. Therefore, chapter X was usually a financial death sentence for the very people that made the decision whether to file a proceeding (old equity and management). On the other hand, under chapter XI, management was usually left in place, there was no absolute-priority Rule (at least since the 1950s), and the debtor was the only party ever allowed to file a plan. It is not surprising then that by 1978, few chapter Xs were filed

and even large public corporations were using chapter XI, which was originally intended for small companies with unsecured trade debt, to restructure.

With the passage of the Bankruptcy Code, Congress decided to merge chapter XI and X into a new chapter 11, which contained many of the provisions of each older chapter. However, because chapter 11 exclusivity is limited and the absolute-priority rule is paramount, chapter 11 has followed chapter X into less use, at least as a traditional reorganization vehicle. That is not to say that there are no chapter 11 cases filed or that no restructurings are done under chapter 11. However, it is fair to say that modern chapter 11 practice consists more of (1) pre-packaged plans because they avoid the vagaries of free-fall chapter 11s, or (2) 363 sales for the benefit of lenders and other creditors. Section 363 sales have become, in essence, foreclosure vehicles that allow for realization of closer to going-concern values than would state foreclosure remedies. Consequently, there are fewer free-fall chapter 11s that are used to fight the secured creditor and save the business for old equity. In fact, it is safe to say that in the current environment, the company that files chapter 11 is “in play.”²

These changes have created levels of certainty for lenders that did not exist before 1978. In the mid-1970s, chapter XI was viewed as a threat to lenders because of the uncertainty of the result. While chapter XI technically did not deal with secured claims, bankruptcy judges were often not inclined to grant relief from stay until a deal was made between the debtor and lender. Since only the debtor was authorized to file a plan, even the secured party needed the debtor’s cooperation to realize greater than liquidation value. Further, unsecured creditors had to be dealt with since they needed to accept the plan by a class vote. All of this created uncertainty as to how long the lender would be delayed in the realization on its collateral and what form of restructuring might take place. Chapter 11, as currently practiced, is often not nearly as threatening to secured lenders as was chapter XI.

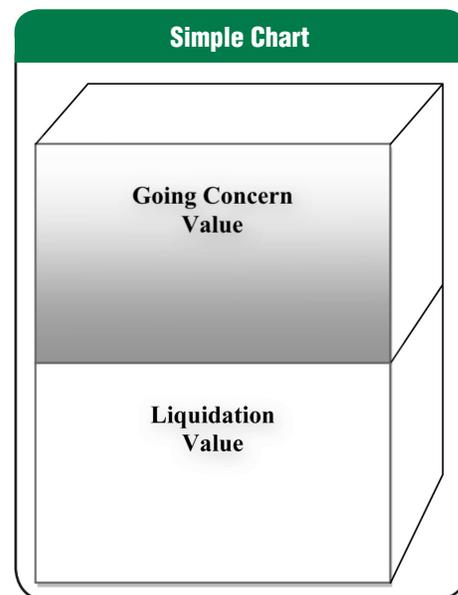
Why Have These Changes Impacted Financial Markets?

The simple chart expresses why such changes have significantly impacted the

financial markets. Usually, as set forth in the chart, the going-concern value is higher than liquidation value. In almost any bankruptcy regime, liquidation value is distributed in some fashion to creditors in their order of priority. The real issue in determining the impact of bankruptcy on the financial markets is to understand how the difference between liquidation value and the going-concern value is distributed among constituencies. Under chapter XI, only the debtor could file a plan, and therefore creditors’ choices were often either to accept liquidation value or to accept the debtor’s plan. The debtor was unlikely to propose a plan that did not provide for the retention of some value by old equity-holders. Today, under chapter 11, increasingly, creditors, in their order of priority, can legitimately hold higher expectations that they will realize the going-concern value of an enterprise. On the other hand, it has become harder for old equity to retain any interest. This all contributes to a higher level of certainty for lenders and other creditors.

Therefore, it can be seen why lenders would be willing to lend deeper and deeper into the balance sheet today than they would have been prior to 1978. If the grey area in the chart was likely to be distributed in part to old equity, that uncertainty would significantly reduce any lender’s appetite to lend against going-concern valuations. If some or all of the grey area were to be distributed to old equity, the value in the grey area would be significantly less likely to serve as the basis for lending deeper and deeper into the asset base. Recovery would be far from certain.

Many people feel that the changes in



¹ For an article discussing how changes in bankruptcy practice have created more certainty for creditors, see Richard E. Mikels and Charles W. Azano, "The More Things Change... Reflections on 34 Years of Practice," 25-Oct. Am. Bankr. Inst. J. 22 (2006) (hereinafter referred to as the "34 Years article").

² These dynamics and their impact on chapter 11 practice are discussed in the article by Richard E. Mikels and Peter S. Kaufman, "Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit," 22-Dec/Jan. Am. Bankr. Inst. J. 36 (2004).

bankruptcy practice have occurred primarily because of changes in the financial markets, such as the rise of “loan-to-own” strategies and increased claims trading, both of which have significant impact on chapter 11 cases. However, if all or a portion of the grey area were likely to be retained by old equity and/or lower-tier creditors in order for more than liquidation value to be realized, then loan-to-own would be a far less effective strategy. The loan-to-own strategy works because, under the present chapter 11, the fulcrum security holders have a reasonable expectation that they will end up with the equity of the company. If chapter XI were still the controlling restructuring regime, a loan-to-own strategy would be far less effective. Likewise, the claims-trading industry needs to be able to assess the likely result of chapter 11 cases. If the only way to realize greater-than-liquidation value were to provide old equity with some value, there would be a serious diminishment in the certainty that allows the claims-trading market to flourish. Therefore, bankruptcy impacts these markets as much as these markets impact bankruptcy.

Are These Changes a Good Thing or a Bad Thing?

The impact of the changes in bankruptcy practice on financial markets has been significant and has both good and bad elements. In the 34 Years article, this was discussed as follows:

In reality, all of these changes have been good for someone and bad for someone else. For example, as chapter 11 administration becomes less flexible and therefore more predictable, that tends to be a good thing for lenders and a bad thing for debtors. Lenders are able to make better underwriting decisions if there is more certainty as to the disposition of the loan in the event the debtor faces financial difficulty. As has happened in the real world, in such circumstances, lenders... comforted by additional certainty, are more willing to make loans...into increasingly risky opportunities. Further, advance rates will tend to increase so that more debt can be placed on the same assets. This is, of course, good in the sense that the aggressive lending stimulates the economy. However, when the inevitable recession occurs, the

more aggressive lending may well transform itself into layers of risk that the economy can no longer absorb, leading to a deeper recession.³

The authors’ prediction in 2006 about the likely severity of the recession that would not begin for over a year was based in good part on a belief that bankruptcy policies and practice in fact have a great impact on the financial markets and the economy.

The changes discussed have been beneficial in that prior to 2008 they contributed to unprecedented vibrancy in the financial markets. Loans became more plentiful, and the economy benefited greatly. However, as in all other aspects of life, too much of a good thing is not necessarily advantageous, and an overheated economy lends itself to “bubbles” that are painful to resolve.

Monetary and fiscal policies clearly have great impact on the financial markets and the economy. The same is true of developments in bankruptcy practice and policy. Certainly the impact of bankruptcy is longer term, and therefore it is harder to perceive its influence. However, what we do in the bankruptcy field and how we do it plays a very significant role in our financial markets and our economy. ■

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³ *Id.* at page 72.