FTI CONSULTING

Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

Michael Eisenband
Consulting Editor
FTI Consulting

AMERICAN BANKRUPTCY INSTITUTE

NAVIGATING TODAY'S ENVIRONMENT

THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING

SECOND EDITION

Consulting Editor
Michael Eisenband

Advisory Board
Carlin Adrianopoli
Amir Agam
Michael Buenzow
Robert Del Genio
Michael Katzenstein
Steven Simms

View the digital version of the guide at:
www.navigatingtodaysenvironment.com

Published by
CAXTON Business & Legal inc.

1 WHO'S WHO: AN INTRODUCTION FOR OFFICERS AND DIRECTORS TO THE TYPICAL PLAYERS IN A RESTRUCTURING TRANSACTION

LEGAL PERSPECTIVE

Willkie Farr & Gallagher LLP

Jeffrey D. Pawlitz, *Partner*

Weston T. Eguchi, *Partner*

James H. Burbage, *Associate*

Distress can incapacitate even the most effectively managed operations. Officers and directors who find themselves managing through such distress — no matter its form — can agree on one thing: the learning curve is steep. Restructuring transactions are notoriously complex: they require an understanding of competing and complicated interests across many actors, demand tremendous time and attention from senior management and the board just when such focus is most needed on the business itself, and move quickly, and often, unpredictably. Understanding core foundational principles — the proverbial lay of the land — of the distressed arena may *actually* spell the difference between a company careening off the rails into a value-destructive liquidation and artfully crafting a comprehensive, multiparty transformative restructuring which best ensures its future success.

This chapter provides officers and directors with a basic primer on the typical "players" involved in distressed company transactions. By plainly describing these players — as well as their roles and primary motivations — this chapter seeks to quickly flatten any learning curve faced by officers and directors new to restructuring transactions.

As an initial matter, this chapter addresses both what restructuring professionals call "in-court" restructuring transactions (the most common being a Chapter 11 bankruptcy) as well as "out-of-court" restructuring transactions (e.g., debt-for-equity exchanges, forbearances and refinancings). Indeed, out-of-court transactions have become more common over the years as the sophistication of interested parties has continued to grow. This chapter does not probe distinctions among these transactions or why one structure or strategy may be favored over another (indeed, all of the knowledge contained within the pages of this book can only marginally reach the necessary depth for that audacious goal). However, understanding the key players who are often present when trouble arises, and their directional motivations, can maximize the likelihood that company leaders take the right first steps early in the process.

The company and its professionals

It is impossible to generalize what distressed companies will need from a restructuring transaction because every situation is different. Companies undertake a restructuring process because they are facing some type of stress. The stress may be caused by general economic or industry-wide factors, or circumstances specific to the company, such as liquidity shortfalls, outsized leverage, pending maturities or defaults under its debt or other capital documents. Addressing the underlying issues, whatever they may be, *in an effective manner* is the ultimate goal of the restructuring process. At the same time, the company must also manage other issues that become more acute in restructuring scenarios, such as a desire to implement its business plan, retain and incentivize its management and employees, protect its customer base and manage vendor relations. All of this, of course, falls under the overlay of actually maintaining the effective operations of the company itself.

General managers ("GM"s) of winning professional sports franchises often serve as able research subjects in the quest to identify model executive traits, and for good reason. Like executives, GMs execute the essential role of assembling the right mix of talent and experience for short- and long-term success. This requires understanding the role each player performs and how that performance affects the performance of others. As with executives, the stakes are high: if they fail to understand these dynamics, they will be required to answer questions — from the fans, the press and the owner.

This analogy can be taken a step further once a company becomes distressed: imagine new rules of the game have been introduced, the way you win the game (or what even counts as winning) has changed, and instead of playing against one opponent, several other teams have now also taken to the field, all while the stakes have become higher. Strategies that were once consistent with your fiduciary duties now run afoul of them given the shifting nature of officers' and directors' legal obligations. You see where we are going. Just as an experienced GM would thoughtfully reconsider his or her team's lineup to best confront these new challenges, so might officers and directors of distressed companies thoughtfully consider and retain the right professional advisors to navigate the complexities of their unique distressed situation.

Here, we focus on three of the most essential advisors to a distressed company: legal restructuring counsel, financial advisors and investment bankers.

— **Legal restructuring counsel:** Once a company has identified the need for a potential restructuring transaction — which often may be 6 to 18 months before any restructuring triggering event — directors and officers should begin consulting with experienced legal restructuring counsel. Restructuring lawyers help companies develop a high-level restructuring strategy, and assist in all aspects of implementing that strategy. For example, imagine a company that knows it could face challenges refinancing a bond issuance that matures in 18 months. Lawyers will help advise officers and directors about the benefits and considerations of available strategies, such as using proceeds of an asset sale to pay down liabilities, seeking a waiver or forbearance from key constituency groups or proactively launching an exchange. Once a strategy has been selected, lawyers advise on available execution tactics for implementation. If the strategy requires Chapter 11 (or the threat thereof, which alone can be a powerful tool), then restructuring counsel will help advise the company's management (often on a daily basis) with tasks such as managing liquidity and messaging to key constituents like customers, vendors and employees. Last, but certainly not least, restructuring counsel help companies establish and execute appropriate decision-making processes to minimize litigation risk, including against officers and directors themselves.

— **Financial advisors:** Financial advisors (often referred to as "FA"s) familiar with the restructuring space are extremely valuable to officers and directors of distressed companies. Much like lawyers, FAs often play an essential role in developing and implementing a high-level restructuring strategy. For example, in many out-of-court restructurings, FAs run forecasts to compare the benefits and risks of competing

transactions. In Chapter 11 restructurings, they help officers manage liquidity, obtain "debtor-in-possession" financing and provide required reporting to lenders. By integrating into the company's daily operations — often spending significant time on-site — FAs provide tremendous support to senior management. Unsurprisingly, FAs also often work hand in hand with senior management to assess the soundness of the company's material contracts and leases in order to develop an optimized go-forward business plan. In some instances, a company may install a senior FA as a "chief restructuring officer" or similar role.

— **Investment bankers:** Distressed companies often engage restructuring investment bankers. In some cases, investment bankers are tasked with selling the company or certain key assets. In other cases, they help companies access lending and capital markets, and ensure officers and directors have accurate and necessary inputs to understand the company's go-forward prospects (e.g., cost of capital, liquidity, availability of strategic transactions). In addition to helping the board, the insights of investment bankers are often essential components to the advice provided by the company's lawyers and FAs.

Company leadership's ability to successfully craft the right combination of advisors to tackle the particular challenges of a situation often will prove paramount to whether a company is able to navigate the dangerous waters of distress; it will serve as the cornerstone upon which all future decisions and processes will be based.

Creditors' groups

A different way of saying "this Company is financially distressed" is saying "this Company has an issue with its creditors." As previously noted, the exact nature of the creditor issue will vary by circumstance; however, the most common is where a company faces a default under an existing debt document or the company's options are constrained by its existing debt documents. Breaching a covenant often is viewed as evidence of a short-term issue or possibly more serious corporate health problems down the line. For example, a company might have a short-term problem if a discrete operational issue leads to a bad financial quarter, causing the company to violate a minimum liquidity covenant. Alternatively, if a company trips a financial leverage test covenant, that may be indicative of a larger, fundamental capital structure issue.

If distressed companies are like professional sports teams preparing for an upcoming season, then creditors are like the team's conference rivals. They too can identify prospective distressed situations over the horizon. Where trouble lurks, similarly situated creditors often will form informal "ad hoc" groups to proactively engage and transact with the company ahead of a restructuring catalyst. The lenders in these groups can span the entire ecosystem of financial lending, including commercial banks, large asset management firms, hedge funds that invest in stressed or distressed debt, and more recently, issuers of collateralized loan obligations. Other investors, recognizing a potential opportunity to acquire control of the company through a restructuring process, may also purchase the debt to pursue a "loan to own" strategy.

The circumstances of the company's challenges will directionally shape a creditor group's strategies and tactics. One reason that negotiations with creditor groups can often be challenging is that creditors are rarely uniformly aligned on acceptable outcomes. For example, some creditors may aim to tighten debt terms to provide more credit or collateral protection. More aggressive creditors, on the other hand, may want to transform a company's fundamental decision-making process by supplementing the board or management with creditor-friendly representatives or by requiring strategic milestones to a preferred outcome (e.g., asset sale or refinancing milestones).

Practical tips for officers and directors to keep in mind when engaging with creditor groups include:

— **Confidentiality:** Companies must ensure that creditor groups preserve confidentiality. News of financial distress often results in unwelcome operational challenges, including tightened

vendor credit terms, key employee departures and deteriorating customer confidence. Maintaining confidentiality also best protects against opportunistic ploys from more aggressive creditors who may seek to trade into a struggling company's capital structure to execute more aggressive control-based strategies in pursuit of a value windfall.

— **Staging discussions:** Companies often work "down" their capital structures to address weaknesses. Said differently, officers and directors generally should commence conversations with their senior-most lenders before focusing on more junior classes of debt or equity (unless and until such senior obligations are shown to be fully secured and therefore "money good"). A company is well-advised, of course, to maintain good relationships with major constituency groups throughout its entire capital structure; the potential duration of restructuring transactions and risk of shifting interests or conditions may change the focus or relevance of key constituencies in unpredictable ways.

— **Understanding the counterparty:** Officers and directors should understand the nature of the debt being restructured in order to understand what realistically can be accomplished. For example, if the restructuring transaction requires an amendment to a bond indenture, then starting negotiations with a creditor group likely may make good sense only if it has the requisite amount of bondholders needed to deliver the vote. Whether corporate debt is closely held or publicly traded will also impact the likelihood of a successful restructuring transaction. Restructuring a series of bonds widely held by thousands of parties through an exchange offer is much harder than restructuring a term loan held by three banks. Understanding whether one restructuring option creates more of a "free-rider problem" than competing alternatives may shape the company's restructuring calculus. Moreover, different parties may have different appetites for investing new capital in the company, which may be driven not only by the fund's credit assessment of the company, but also by their fund structure or their stage in the lifecycle of the fund. Fund investment parameters may also drive whether the lender is willing to (or even can) accept certain forms of exchange consideration, such as equity.

Equity

Distributable value in corporate reorganizations flows like a waterfall — secured creditors generally must be paid in full from collateral before unsecured creditors, and unsecured creditors generally must be paid in full before equity holders. Depending on the situation, a company's equity owner might be "out of the money" and play very little role in a restructuring transaction, or be the chief engineer of an out-of-court restructuring designed to protect its existing equity position. When thinking about the role of equity, officers and directors should keep a few key concepts in mind:

— **Public versus private companies:** If a company is privately held — such as a private equity firm portfolio company or family-owned business — the board dynamics may be very different from those of a publicly traded company. Privately held company boards often include individuals who are not considered "disinterested." Officers and directors must understand their own potential conflicts, and how the collective composition of the board could shape restructuring negotiations. For example, portfolio companies with many conflicted board members generally have the potential to cause more concern for creditor groups than publicly traded companies with numerous disinterested board members. This dynamic could determine how much flexibility creditors are willing to give the company post-restructuring transaction. In addition, boards composed of "interested" directors are more likely to have their loyalties questioned, including through claims that certain actions would violate their fiduciary duties.

— **Independent directors and special committees:** Private equity sponsors or other equity holders might try to offset the perception that a company board is favoring equity by appointing disinterested "independent" directors. If there are multiple

independent directors, they might form a special committee that evaluates certain transactions without involvement or deliberation of "interested directors." A process that lacks actual (or perceived) impropriety can minimize potential future assertions of directors' and officers' liability and the risk that courts may later second-guess the company's decisions. Over the past decade, it has become increasingly common for independent directors and special committees to hire their own special counsel (i.e., separate from the company's restructuring counsel) to further ensure procedural and substantive impartiality. By proactively taking these corporate governances steps, officers and directors help avoid the need for separate, potentially more hostile investigations later in the restructuring process.

— **Interests:** While the exact interests of equity holders will depend on the economics of the situation, two interests are often at the top of their minds. *First*, protecting their prior investment in equity value and potential upside to the extent possible. Perhaps the simplest way to accomplish this is by ensuring that existing management can focus on operating the business. *Second*, if the company has filed for bankruptcy, equity holders usually will seek some reassurance that they (and any affiliated personnel) will not be sued after the bankruptcy case. In most Chapter 11 cases, a plan of reorganization accomplishes this goal through releases, which can either be consensual or, in narrow circumstances, non-consensual.

Official committees

Up until this point, you might think that only large financial institutions have a say in corporate restructurings. While they are undeniably loud voices in the room, the Chapter 11 bankruptcy process ensures that other, smaller economic actors will also be heard. This is most prominently accomplished by the appointment of "official committees," each of which is tasked with representing the collective interest of similarly situated parties. As an initial matter, official committees are only formed in the context of Chapter 11 proceedings. The most common official committee is the official committee of unsecured creditors, which is formed in most complex Chapter 11 bankruptcies. Some bankruptcy cases include appointments of multiple official committees, such as an official committee of tort claimants or even an official equity committee.

Official committees are appointed by the United States Trustee's office, a branch of the Department of Justice. In forming an unsecured creditors' committee, the United States Trustee generally seeks to appoint five to seven sizable unsecured creditors with differing natures of unsecured claims. It is often common to see landlords, trade creditors, indenture trustees or litigation counterparties serve together on an unsecured creditors' committee. The diverse mix of creditors — some of whom may not be familiar with the Chapter 11 process — can complicate the company's negotiations with the committee; however, any committee members lacking sophistication will have the benefit of separately retained legal and financial advisors (whose fees are paid by the debtors' estates).

Official committees owe fiduciary duties to the stakeholders they represent. The discharge of these duties often manifests itself in attempts to increase their stakeholder constituents' realized recoveries through actual or threatened litigation and other forms of process leverage. Moreover, as fiduciaries, official committees are typically given a significant amount of respect by bankruptcy judges, who also expect official committees to serve as de facto checks on the debtors throughout the case. This deference — and the fact that creditor committees are typically one of the more sympathetic actors in Chapter 11 cases — makes official committees powerful allies (and adversaries) in the Chapter 11 process.

United States Trustee's office

The United States Trustee is the government "watchdog" over bankruptcy cases. The office has a variety of roles throughout a Chapter 11 case, including serving as a check on the debtor before the appointment of a creditors' committee, appointing official committees and collecting bankruptcy-specific fees owed to the federal government.

Officers and directors can associate the United States Trustee with an underlying principle of the Chapter 11 process: extreme disclosure and transparency. Once a company files for Chapter 11 relief, for example, it must file an exhaustive amount of financial information, including monthly operating reports, schedules of the company's assets and liabilities and statements of past financial affairs. In addition, the United States Trustee must hold a meeting where the company's creditors can ask a member of the debtors' senior management team questions about its financial disclosures. Unlike the many economically motived restructuring players, the United States Trustee represents an entire different set of interests — protection and clarity of process — that can further serve to complicate the company's restructuring goals.

Bankruptcy judges

The final key actor worthy of discussion arguably holds the most power in a Chapter 11 case — the bankruptcy judge. Bankruptcy judges oversee the entire bankruptcy court process: one day they are entering ministerial orders, and the next they are ruling on legal issues that shift millions of dollars in value (or more) between constituencies. As courts of equity, bankruptcy judges have tremendous flexibility under federal law to fashion equitable results.

Each federal district court has its own set of bankruptcy judges. Certain jurisdictions are known for handling complex Chapter 11 cases, such as Delaware, the Southern District of New York and the Southern District of Texas. Occasionally, judges in these jurisdictions might have rulings or practices that prompt a company to file in a specific jurisdiction, or avoid a different jurisdiction. Understanding how a specific judge is likely to react to proposals made throughout the case — such as granting certain relief on the first day of the case to ensure an orderly transition into Chapter 11, granting third-party releases, approving management incentive plans or how much deference will be given to a creditors' committee — helps ensure that the company will be able to navigate the Chapter 11 process smoothly. Accordingly, it is not uncommon for companies to hire local counsel that are deeply familiar with their local bankruptcy judges.

Conclusion

Restructuring transactions are often opportunities for companies to right-size their capital structures and optimize their go-forward business plans. To maximize this opportunity, corporate decision-makers must understand and appreciate the unique dynamics each restructuring presents. We hope this chapter provides directors and officers with the tools to begin thinking through restructuring issues, and convinces them to engage experienced restructuring professionals to help guide them early in the process.

Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring (the Book) contains summary information about business practices as well as legal and regulatory aspects of managing businesses. It is current as of the date of its initial publication (November 2022). Although the Book may be revised and updated at some time in the future, FTI Consulting, Inc. (FTI), the publishers, and the authors disclaim any duty to update the information contained in the Book, and will not be liable for any failure to update such information. FTI, the publishers, and the authors make no representation as to the completeness, accuracy or currency of any information contained in the Book. To the extent permitted by law, FTI and all contributor firms excludes all liability for any loss or damage arising in any way including by way of negligence.This book is written as a general guide only. It does not constitute and should not be relied upon as a substitute for specific professional, legal or financial advice. Professional advice should always be sought before taking any action based on the information provided. Nothing in this book is legal advice, nor does it constitute the establishment of any attorney–client relationship. Every effort has been made to ensure that the information in this book is correct at the time of publication. The views, opinions or recommendations expressed in this book are solely those of the authors and do not in any way reflect the views, opinions, recommendations of FTI. FTI, the publishers, and the authors do not accept any responsibility for any errors or omissions contained herein. It is your responsibility to verify any information contained in the Book before relying upon it.

www.navigatingtodaysenvironment.com