

# An Englishman in New York: Some Thoughts on the U.S. Approach to Business Restructurings<sup>1</sup>

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**Editor's Note:** *This European Update has a whiff of Alistair Cooke about it. It is the reflections of an Englishman on the restructuring regime which he discovered in the United States and was originally intended for a predominantly U.K. audience (rather like Cooke's "Letter from America," which ran weekly for 58 years). It is included here, both because such observations are one of the most influential ways of "exporting" chapter 11 methods and philosophies, and also because, despite a trend towards convergence in restructuring techniques, it would not be appropriate to assume that all features of chapter 11 can be replicated in Europe.*

I must start with a confession: I have converted to chapter 11! Theologically speaking, I'm a practising U.S. lawyer who strictly follows the dictates of the U.S. Code!<sup>2</sup>



Sandy Shandro

This all came about following a decision to move to Davis Polk & Wardwell in New York in 2003, where I had the good fortune to be a partner for three exciting years. I worked with a superb team of bankruptcy lawyers from whom I

learned a great deal.<sup>3</sup>

I vividly recall an early conversation with a senior workout banker shortly after my arrival in New York. We were discussing, with increasing intensity, the relative merits of the reorganization regimes in the United States and the United Kingdom. He had recently endured a bad experience in the London market and was struggling to locate either

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the rescue culture of which I repeatedly spoke or a recognizable reorganization regime. Despite my confident assertion that the U.K. system was flexible and effective (you could give effect in the United Kingdom to any restructuring that could be done under chapter 11, I said), he was not at all persuaded that the U.K. system was to be taken seriously and

remained puzzled that I could not see its evident weaknesses.<sup>4</sup>

I continued the debate in my head long after that discussion, and as I started to become more deeply involved with the chapter 11 process, I began to appreciate just how powerful a vehicle it is for achieving a restructuring result—in truth, a juggernaut—when driven by the commercially minded and activist bankruptcy bench.

I had been closely involved with U.S. bankruptcy proceedings while practising in London and before moving to Davis Polk in New York, but there is inevitably a world of difference between being an observer, albeit an active one, and being a participant. Seeing things from inside the system gives you a very different perspective!

Over time, I developed a clearer sense of what my banker friend was telling me and how the U.S. approach involved a fundamentally different mindset and style—a different set of expectations and

ambitions about the desired business outcome of the reorganization. The main message was that the focus of the U.S. system was to get to grips with the debtor's problems and to resolve them through the debtor's rehabilitation—to restore the debtor's financial well-being through whatever radical surgery was required—often involving a recapitalization and rewriting of the balance sheet and an operational and management restructuring.

The implicit criticism of the U.K. model was, of course, that traditionally restructuring options were limited and too often resulted in reschedulings (which tinkered with rather than resolved the problems of the debtor's business or capital structure) and, through the receivership mechanism, produced too many asset or business sales. Things have been changing on both sides of the Atlantic, and this analysis was altogether too simplistic, but there was some

element of truth within it.

The legal framework established by the Bankruptcy Code had promoted, and the players in the financial and securities markets had bought into, an approach that focused, where possible, on fixing the capital structure and on rehabilitation. Banks were prepared to take equity to the extent allowed by applicable regulatory constraints, and wanted to see long-term solutions to the debtor's underlying problems. Major re-engineering of the debtor's balance sheet was enormously helped by the strength and depth of, and liquidity generated by, the U.S. securities and distressed debt markets.

The fact that the chapter 11 system has traditionally been debtor-friendly and limits the rights and leverage of secured creditors is well-known, but to understand how strong the debtor's position is in the U.S. system compared with the U.K.'s, you need to see the full range of rights and powers given to a debtor.

The debtor has the benefit of a broad automatic stay (covering all actions, with certain limited exceptions such as police or regulatory activity, arguably aimed at

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<sup>1</sup> With apologies to Sting!

<sup>2</sup> Well, almost: After years of acting for banks, it has proved impossible to stop being sympathetic to secured creditors and to retaining a fondness for the simple joys of a rapid receivership appointment!

<sup>3</sup> I have recently returned to London and am now a partner in the Restructuring and Insolvency Group at Freshfields Bruckhaus Deringer.

<sup>4</sup> U.K. lawyers engaged in the debate over the relative merits of the U.S. and U.K. systems can take some comfort from the fact that most U.S. law scholars regard equity receiverships (with appointments by the court)—a creature of English law—as being the foundation of U.S. reorganization law. Those interested in the historical context should read Prof. David Skeel's excellent *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton University Press, 2001).

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enforcing or collecting a pre-bankruptcy claim); plan exclusivity, being the right initially to control the process for formulating and negotiating a reorganization plan; the power to assume or reject executory contracts and unexpired leases (including the ability to reject—disclaim, in U.K. terms—contracts that create quasi-property rights such as options); the invalidation of contract termination rights conditioned on insolvency or the financial condition of the debtor—so-called *ipso facto* clauses—in executory contracts and unexpired leases; the power to obtain post-petition financing and, in some circumstances, to grant security interests ranking ahead of existing mortgages and liens; the power to sell property free and clear of liens; various limitations on the rights of secured creditors (including the invalidation of after acquired property clauses as they relate to property acquired by the estate after the start of the bankruptcy); the cramdown power (the ability if certain detailed conditions are met to confirm a plan despite the fact that a class of creditors has voted against it—this does not exist under U.K. law); and the lower voting majority required to approve a plan (the Bankruptcy Code requires a vote of only two-thirds in amount—rather than three-quarters in amount under the U.K. system—and a majority in number).

But it is not just the rights given to the debtor by the Bankruptcy Code that make a difference; there are various institutional factors that are significant. The litigation context is particularly important.

The Code was drafted to promote negotiation among creditor and shareholder groups and contains provisions that give all parties in interest some negotiating leverage, if sometimes only in the form of the ability to delay the ultimate confirmation of the plan! Bargaining in chapter 11 cases takes place in the shadow of bankruptcy court litigation and, while not always the case, chapter 11 can bring the process of negotiating the reorganization into the courtroom.

These proceedings are conducted, at least to U.K. eyes, with considerable informality and are presided over by an assigned bankruptcy judge<sup>5</sup> who sees the case from beginning to end, whose

approval is needed for transactions outside the ordinary course of business, and who sees support for the debtor in the early stages of the case, and promotion of a successful reorganization and the encouragement of settlements as important parts of the job. Consequently, one of the guiding principles is that chapter 11 rewards parties who are actively involved in the process and make it clear to other parties that they are prepared to protect their rights in bankruptcy court if an acceptable deal cannot be negotiated. This explains why those who are used to the U.S. system are so pro-active (“aggressive” to some) and comfortable with taking disputes to court.

However, while the combination of the Code and the continuous involvement of an activist court create the conditions for a strong debtor-led procedure, the chapter 11 process has seen a number of significant changes in recent years, some of which are driven by law reform and some by market developments. Some bemoan, but others applaud, the fact that it is no longer the force it once was. Amendments to the Code over a decade have given added protections to certain classes of creditors—labeled by critics of the reforms as “special interest groups”<sup>6</sup>—such as aircraft financiers, commercial property owners and counterparties to financial contracts, and the creditor-friendly changes introduced by the 2005 reforms<sup>7</sup> have improved the position of various creditors (*e.g.*, landlords and suppliers), and weakened the leverage of the debtor.

These changes are seen as compounding the trend of increasing creditor control (through the use of tight covenants in post-petition financing documentation and of chief restructuring officers appointed at the instigation of creditors), increases in sales of the debtor’s business during the chapter 11 and pre-packaged or pre-negotiated reorganization plans (where plan terms are agreed before the filing), and quicker exits. In addition, the continuing growth of claims trading brings to the negotiating table, at all levels of the capital structure,

experienced professionals who specialize in recapitalizing distressed businesses—and they tend to have strong views as to the timetable for emergence from the case, management strategies and exit terms. Most restructuring negotiations take place primarily between senior and junior creditors, although with hedge funds and other institutional investors acquiring senior debt, there can be tensions and bargaining within creditor classes (negotiating the terms of shareholder agreements to be entered into upon exit from the bankruptcy among banks and funds can be fun!).

Of course, chapter 11, even in this somewhat diluted form, still has its critics. Many would say that its benefits come at too high a price—the costs are substantial both because of high legal and professional fees (in part because every document is turned into a pleading) and also because of the amount of time and resources that need to be devoted to the proceeding. There are many who cite the reorganization recidivists—the chapter 22s and 33s—as evidence of the system’s failure to achieve the results that its promoters proclaim as its *raison d’être*. And there are many who point out that the decision-making process before different bankruptcy courts<sup>8</sup> across the country can be rough and ready and outcomes difficult to predict (a current topic of debate is the significance of valuation evidence in cases where a cramdown of junior creditors is contested and the problems caused by the unpredictability of judicial valuations).<sup>9</sup>

In many respects, chapter 11 has now evolved into a form of distressed M&A and a mechanism for effecting changes in corporate control; in theory and in practice, reorganization is a change of control transaction involving a sale of the debtor’s business to its creditors.<sup>10</sup> Of course, in recent years, indeed well before my trip across the big pond, U.S. methodologies and models have found their way to Europe with the influx into

<sup>8</sup> The choice of venue can have a major impact on the case because the law on certain topics varies from court to court. Forum-shopping in chapter 11 cases has caused a heated debate—see Prof. LoPucki’s *Courting Failure* (University of Michigan, 2004)—which contains some entertaining war stories about major chapter 11s, but also some criticism of senior bankruptcy judges.

<sup>9</sup> See an excellent recent article by Prof. Baird and Don Bernstein, “Absolute Priority, Valuation Uncertainty and the Reorganization Bargain” 115 *Yale L. J.* 1930 (2006).

<sup>10</sup> The empirical and academic literature relating to U.S. bankruptcies is extensive—much more so than exists in the United Kingdom—although there are fewer good textbooks in the United States.

<sup>5</sup> I was immensely impressed with the quality of the bankruptcy judges I saw in action while I was in New York.

<sup>6</sup> See, *e.g.*, Miller and Waisman, “Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-first Century?” 78 *Am. Bankr. L. J.* 153.

<sup>7</sup> The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

the European markets of experienced U.S. bankers, investors and professionals and U.S. funds. As a result, there has been a major shift in thinking and practice and a desire in some quarters to replicate the style and methods of the chapter 11 process (we have even seen U.S. Supreme Court opinions being cited in skeleton arguments in recent litigation concerning contested schemes of arrangement!).

Furthermore, whilst the reforms to the U.S. system mentioned above have strengthened the rights of creditors, recent reforms in the United Kingdom,

following the Enterprise Act 2002, have strengthened the administration regime, introduced into it and have given precedence to the concept of rescuing the company as a going-concern and weakened the position of secured creditors by eliminating the right, save in certain exceptional cases, to appoint an administrative receiver. So we now have some level of convergence, even though local legal cultures remain resilient, and it's dangerous to assume that the two systems are, or can be made, to replicate one another. For example, administration and schemes of arrangement are still very

different from chapter 11 (there is a temptation for some to equate a scheme with a chapter 11 plan, but the three sections of the Companies Act 1985 that regulate schemes, even with the judge-made law supplementing the statute, are a long way from the detailed provisions of the Code), although I have little doubt that the U.S. expatriate community, with a little help from the chapter 11 converts, will continue to reshape the landscape of European restructurings well into the future! ■