AMERICAN BANKRUPTCY INSTITUTE

Winter Leadership Conference

Roadblocks and Detours: Strategies for Enhancing Creditor Recovery

CONCURRENT SESSION

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Milbank LLP | New York

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Brad Orelowitz
The Michel-Shaked Group | Boston

Hon. Karen B. Owens
U.S. Bankruptcy Court (D. Del.) | Wilmington

2024

Roadblocks and Detours: Strategies for Enhancing Creditor Recovery

Speakers

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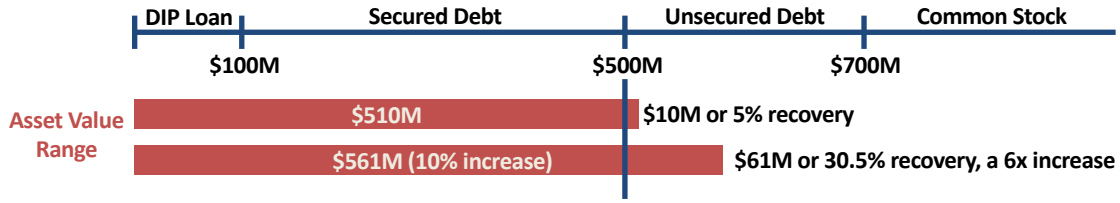
How Valuation Can Assist a Committee

- Allocation of value
- Asset sales
- Collateral valuations
- Litigation issues
- Damages calculations
- Litigation trusts
- Recovery actions
  - Fraudulent conveyance
  - Preference

Allocation of Value

Determination of Fulcrum

- Allocating value is a critical and sensitive task that requires careful precision.



- Even a small change in the determined value of the company's assets can significantly change the recovery rate of unsecured creditors:
  - Unsecured creditors' claims total $200M ($700M - $500M). If the company's assets are determined to be worth $510M, then unsecured creditors would receive $10 ($510M - $500M), or **5% of their total claim**.
  - Otherwise, if the company's assets are determined to be worth only 10% more, or $561M, then the unsecured creditors would receive $61M, or **30.5% of their total claim**. This is an increase of six times.

Recovery Actions: Fraudulent Conveyance

The Case of Neiman Marcus

- Neiman Marcus ("NMG"), a retail company with more than $5 billion of debt, was owned by a PE firm. The PE firm distributed a very valuable asset of Neiman Marcus, the MyTheresa business, to its subsidiaries, effectively moving the asset out of the reach of creditors.
- During this period, Neiman Marcus experienced a decline in the price of its public debt, together with multiple downgrades of its corporate credit rating.

Corporate Credit Rating		
Date	Rating	Rating Action
9/10/13	B2	On Watch - Possible Downgrade
10/7/13	B3	Downgrade
3/15/17	Caa2	Downgrade
10/26/18	Caa3	Downgrade
3/27/19	Caa3	Affirmed
5/20/19	Caa3	Affirmed
5/18/20	WR	Withdrawn

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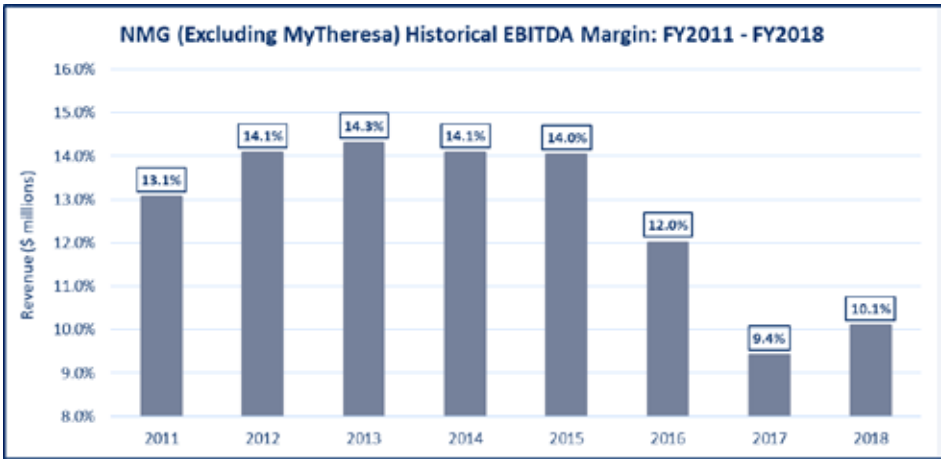
Recovery Actions: Fraudulent Conveyance

The Case of Neiman Marcus

- Prior to the distribution of MyTheresa, Neiman Marcus (excluding MyTheresa) saw a significant drop in its EBITDA margin:



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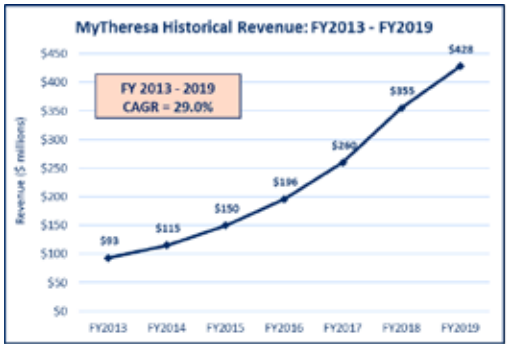
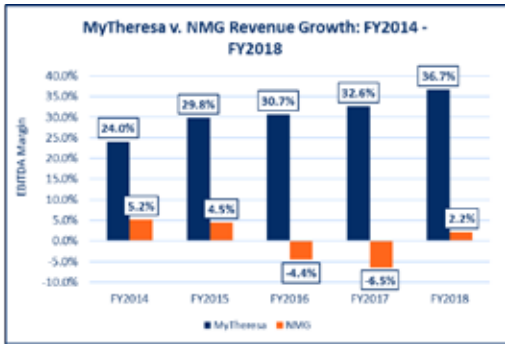
Recovery Actions: Fraudulent Conveyance

The Case of Neiman Marcus

- Contrary to the financial results of Neiman Marcus (excluding MyTheresa), MyTheresa was a high growth company with its revenues growing from $93 million to $428 million, from FY2013 to FY2019.
  - MyTheresa's revenue compounded annual growth rate ("CAGR") over the period was 29.0% compared to NMG's revenue CAGR of only 0.2%.





Recovery Actions: Fraudulent Conveyance

The Case of Neiman Marcus

- Projections used in various valuations of the company over time:

Projections:	Terminal EBITDA Margin
April 2016 - Valuation	11.2%
February 2017 - Management Projections	11.7%
March 2017 - Valuation (Designation)	**7.6%**
April 2017 - Valuation	9.5%
July 2017 - Investment Bank's Valuation	11.3%
April 2018 - Valuation (Distribution)	**6.9%**
April 2019 - Valuation	9.8%

- A valuation firm issued a valuation opinion for MyTheresa at the designation and distribution dates.
- I was retained to value both Neiman Marcus (excluding the value of MyTheresa) and MyTheresa.
  - Neiman Marcus's $5 billion debt burden left the company insolvent at the time of the MyTheresa business distribution.
  - I valued MyTheresa at almost $1 billion.

Recovery Actions: Preference

The Case of FoxMeyer

- FoxMeyer was a drug distributor. And one of six companies that controlled 85% of the market. FoxMeyer was underperforming all its peers.
- FoxMeyer operated a distribution network around the country, with 19 warehouses and numerous delivery vehicles.
- FoxMeyer spent $100 million on its distribution systems in the year prior to bankruptcy.
- FoxMeyer's "Selling Gross Margin" was negative.
  - For example, FoxMeyer purchased drugs for $100 and sold them for $99.
  - Upon prompt payment, FoxMeyer received a rebate from vendors, which then lowered its cost to below $99 (its "Buying Gross Margin").
- FoxMeyer had an average daily cash shortfall of $375,000 from April 1, 1991 through March 31, 1996.

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Recovery Actions: Preference

The Case of FoxMeyer

- FoxMeyer had $600 million of unsecured debt and needed to obtain covenant waivers.
- The company was distressed and refinanced its unsecured loan with a secured loan of $750 million.
- All assets were pledged as security for the new loan.
- Creditors were concerned and collectively reduced their credit limits.
- FoxMeyer was required to pay down the amount in excess of the credit limits with cash on hand.
- FoxMeyer did not have the cash to pay vendors within 30 days, losing its prompt payment rebate.
- FoxMeyer could not keep up the volume required with razor thin margins to cover its fixed overhead.
- The company filed for bankruptcy a little over two months later.
  - I was retained to determine if the company was insolvent as of refinancing date.

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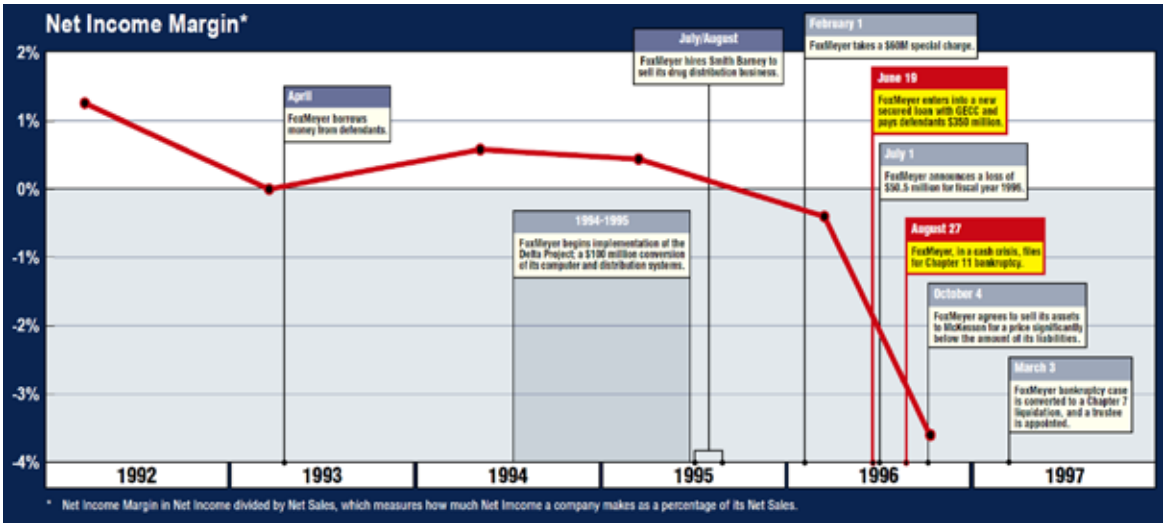
Recovery Actions: Preference

The Case of FoxMeyer



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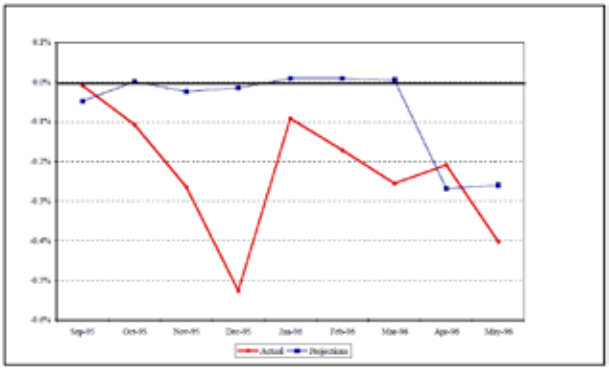
Recovery Actions: Preference

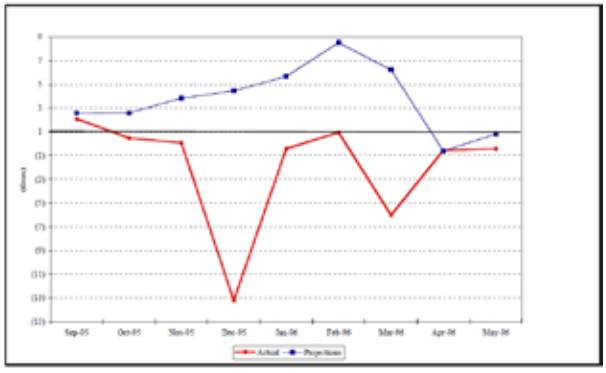
The Case of FoxMeyer

- FoxMeyer's projections ultimately proved overly optimistic, as the company has consistently failed to meet them.

Gross Margin on Sales



Interest Coverage Ratio



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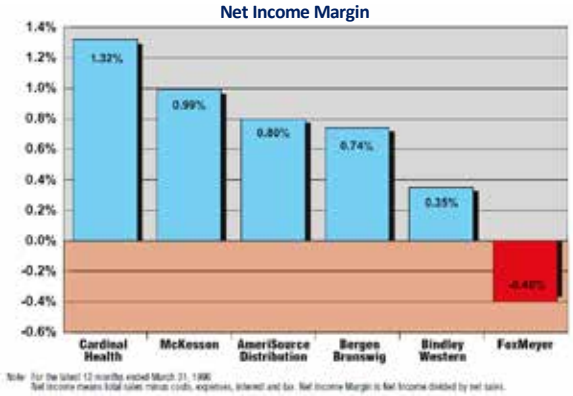
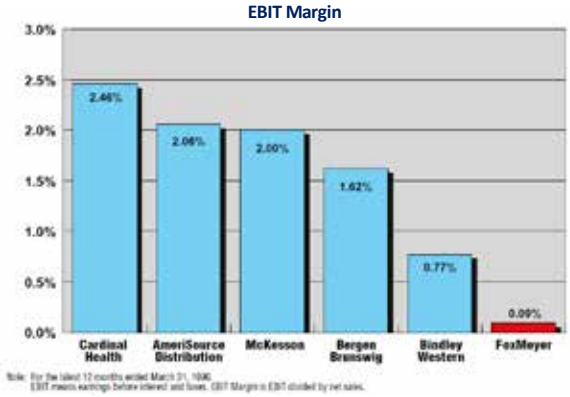
Recovery Actions: Preference

The Case of FoxMeyer

- FoxMeyer underperformed its peer group leading up to its bankruptcy.





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Slowing Down an Expedited Sale – Objections to DIP Financing

While certain favorable financing terms may be permitted as a reasonable exercise of the debtor's business judgment, bankruptcy courts do not allow terms in financing arrangements which convert the bankruptcy process from one designed to benefit all creditors to one designed for the unwarranted benefit of the postpetition lender.

In re Berry Good, LLC, 400 B.R. 741, 747 (Bankr. D. Ariz. 2008)

- Realistically, UCC is usually the only party positioned to challenge an overreaching DIP Facility

- Identify DIP Lender's Motivation (Fees & Interest; Control of Process; Loan to Own)
  - According to Debtwire, in 2022, only $ 1.9 billion (or 21 percent) out of $ 9.4 billion in DIP financing and 16 (or 18 percent) out of 89 DIP facilities were provided by "true third-party lenders" that had "no meaningful connection to a debtor" apart from the DIP financing.

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Slowing Down an Expedited Sale – Objections to DIP Financing

- Potential Roadblocks & Speedbumps
  - DIP Facility is too short
  - DIP Facility is too small
  - DIP Facility is too expensive (not just interest, but fees, fees, and more fees)
  - DIP Facility is too controlling (unreasonable case-determinative milestones)
  - Disparate Professional Fee Carveouts
  - DIP Facility Improperly Encumbers Estate Causes of Action

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Maximizing Recoveries in Sale Context

- If one investment banker is good, then two investment bankers must be [_____].
  - Second banker can vet adequacy and bring new perspectives, but doubles the cost (even when they fail to bring a new buyer to the table)
- Limit Credit Bid Rights - right to credit bid is not absolute and may be limited or denied "for cause"
  - Courts denying motions to limit credit bidding rights. *See, e.g.*, *In re Empire Generating Co, LLC*, 2020 WL 1330285 (S.D.N.Y. Mar. 23, 2020); *In re Aéropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016); *In re Tempnology, LLC*, 542 B.R. 50, 69 (Bankr. D.N.H. 2015) *aff'd*, 558 B.R. 500 (B.A.P. 1st Cir. 2016), *aff'd*, 879 F.3d 376 (1st Cir. 2018); *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014); *In re Murray Metallurgical Coal Holdings, LLC*, 614 B.R. 819, 835 (Bankr. S.D. Ohio 2020)
  - Other courts have found "cause" to limit or deny such rights. *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014); *In re Figueroa Mountain Brewing, LLC*, 2021 WL 2787880 (Bankr. C.D. Cal. July 2, 2021); *SEC v. Capital Cove Bancorp LLC*, 2015 BL 449611 (C.D. Cal. Oct. 13, 2015); *In re Family Christian, LLC*, 533 B.R. 600 (Bankr. W.D. Mich. 2015); *In re The Free Lance-Star Publishing Co.*, 512 B.R. 798 (Bankr. E.D. Va.); *In re RML Dev., Inc.*, 528 B.R. 150, 155-56 (Bankr. W.D. Tenn. 2014)
- Try focusing on reducing the pool:
  - Maximize trade debt assumed through sale
  - Subordinate or cap recovery on account of deficiency claim (consider DIP lender motivation)
- Flag "Catch & Kill" acquisition of estate causes of action (tantamount to a release)
  - Sale of estate causes of action should require valuation and incremental cash contribution

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Maximizing Recoveries in Sale Context

- When all else fails…. Seek to convert the case to chapter 7

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Secured Creditor Strategies – DIP Financing Roll-Ups

- Where the prepetition secured lenders become a source of DIP financing, such lenders may seek to "roll-up" their prepetition loans into DIP financing loans
- As DIP facility claims, such rolled-up claims must be paid in full in cash if a reorganization plan is to be confirmed, thereby eliminating any cram-down risk
- Roll-ups typically take one of two forms:
  - A pro rata roll-up that allows each lender to roll-up an amount proportionate to its share of the prepetition loan, regardless of whether such lender provides any new money as part of the DIP financing
  - A roll-up that only applies to the debt of those prepetition lenders that participate in the new money DIP Financing; those lenders that do not provide new capital do not receive the benefits of the roll-up
- Typically roll-ups occur at anywhere from 1x-2x the amount of new money provided but larger rollups have been approved (*True Religion* was approved as a 4x roll-up)
- Even a 1x roll-up can be very valuable to new money lenders
  - Such roll-ups can, but do not always, materially diminish the amount of distributions that otherwise would have been received by the pre-petition 1L debt

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Secured Creditor Strategies – Equity Conversion

- Some DIP financings have included the option to convert outstanding amounts on the DIP loan to equity in the reorganized debtor
  - **Equity Upside**
    - Such conversions grant lenders a potential equity upside
    - They also allow debtors to reduce the amount of cash they must raise in unfavorable markets to repay the DIP loan on emergence from bankruptcy, which is desirable for lenders wishing to execute a loan-to-own strategy
  - **Equity conversions typically occur at a discount to Plan Value**
  - **Certain equity conversions have been found to be improper sub rosa plan**
    - ***See, e.g., In re Latam Airlines Grp., S.A.,* 620 B.R. 722 (Bankr. S.D.N.Y. 2020) (rejecting proposed DIP Facility where Debtors would have right to convert DIP to equity at a 20% discount to plan value)**
  - **Other equity conversions (at either the Debtors' or lenders' election) have been approved**
    - ***In re Avianca Holdings (Debtors' election to convert at an 8.5% discount to plan value if certain conditions met)***
    - ***In re Aeromexico (Lenders' election to convert at plan value)***

Secured Creditor Strategies – Case Controls

- Secured Lenders will often seek to have case controls approved (whether as part of a DIP financing, cash collateral order, or RSA).

- These controls include:
  - Line Item Budget Variance Testing
  - Plan and/or Sale Milestones
  - Consent Rights with respect to significant pleadings
  - Hair-Trigger Termination Events

Faculty

Dennis F. Dunne is a partner with Milbank LLP in New York and a member of the firm's Global Executive Committee. He is also global chair of the firm's Financial Restructuring Group, and he represents companies and creditors in reorganization cases and out-of-court workouts, acquirors of financially distressed companies, providers of financing, and boards of directors of public and private companies. Mr. Dunne plays a leadership role in these matters, frequently as counsel to companies or official and unofficial committees representing key creditor constituencies, such as bondholders, agents for lender syndicates, and large debt or equity-holders. He also regularly represents private-equity funds, hedge funds and other financial institutions acquiring control positions in financially distressed companies, both in and out of court. In addition, Mr. Dunne assists prospective providers of debtor-in-possession financing in structuring, structures and documents exchange and tender offers, and regularly advises boards of directors of public companies on corporate governance and fiduciary duty matters in the restructuring context. His engagements have ranged across a wide array of industries, including automotive, airline, apparel, cable and broadcasting, chemical, construction, gaming, health care, housing, infrastructure, manufacturing, pharmaceutical, energy, retail, shipping, telecommunications and textiles. Mr. Dunne is a Fellow and served as the Second Circuit Regent in the American College of Bankruptcy, and he frequently speaks on restructuring and related topics at conferences around the country. He is also a Fellow in the International Insolvency Institute, and has been elected as conferee to the National Bankruptcy Conference (NBC), for which he currently serves on its executive committee. He also is a member of the Federal Bar Council. Mr. Dunne is a co-author of *Collier on Bankruptcy* and co-authored a chapter titled, "Evaluating strategic debt buybacks: How to pursue effective de-leveraging strategies" in *Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring*. He is a frequent speaker at conferences sponsored by ABI and the National Conference of Bankruptcy Judges. Mr. Dunne has been listed in the *K&A Register of the Leading Bankruptcy and Financial Restructuring Lawyers and Financial Advisors in the United States*, as well as in *Chambers Global*, *Chambers USA*, *The World's Leading Lawyers for Business*, *Lawdragon 500* and *The Best Lawyers in America*, and he was listed as one of *Turnarounds & Workouts*' "Top Restructuring Lawyers" of 2008, 2011 and 2014. He received his B.A. from Williams College and his J.D. from New York University School of Law.

Amir Gamliel is a partner with Perkins Coie LLP in Los Angeles and represents clients in business reorganizations, out-of-court restructuring work, and litigation involving complex financial transactions. He is experienced in the finance sector, covering areas including commercial mortgage-backed securities, technology, aerospace, real estate and retail industries. Mr. Gamliel counsels secured creditors, including through the largest master and special servicers in the U.S., as well as unsecured creditors ranging from licensors of intellectual property to major landlords, property lessors and committees. He advises financially troubled businesses regarding bankruptcy and nonbankruptcy alternatives, and directors and officers of such businesses on mitigating litigation risk. Mr. Gamliel represents buyers in distressed asset and debt acquisitions, and he maintains a robust practice defending parties in preference and fraudulent-transfer avoidance actions. He also counsels on complicated supply-chain issues, including access and accommodation agreements, assignments for the benefit of creditors and orderly dissolutions. Experienced in business litigation in state and federal courts and arbitrations, Mr. Gamliel has tried cases ranging from contested plan confirmation hearings and

avoidance actions (fraudulent transfer and preference litigation) in bankruptcy to business torts, trade secrets and commercial contract disputes outside of bankruptcy. He has successfully appealed decisions in both state and federal court, and he frequently represents parties in post-trial judgment-enforcement actions. Mr. Gamliel received his B.A. in business economics *magna cum laude* and Phi Beta Kappa from the University of California, Los Angeles in 2006 and his J.D. in 2009 from UCLA School of Law, and he completed an executive program in 2017 at UCLA Anderson School of Management.

Brad Orelowitz, CPA is a managing director of The Michel-Shaked Group in Boston. For more than 30 years, he has provided business consulting services to boards of directors, investors, shareholders, law firms and governmental agencies nationwide, including more than 25 years with MSG. Prior to joining MSG, Mr. Orelowitz was the CFO of a retail business and an audit manager for a public accounting firm. His practice at MSG focuses on valuation, bankruptcy, damages, accounting, securities, capital markets, employment, and pensions and retirement plan issues. Mr. Orelowitz has performed valuations, solvency and damages analyses in numerous industries, including cable, drug distribution, education, energy, financial services, health care, industrial, insurance, leisure, manufacturing, media, medical, pharmaceuticals, real estate, retail, software, sports franchises, technology, telecommunications, tire and rubber and tobacco. A significant number of his assignments involved financial distress, restructuring, solvency, fraudulent conveyance and preference matters. In bankruptcy assignments, he has represented debtors, lenders, creditors and equityholders. Mr. Orelowitz has written on topics such as valuation, bankruptcy, pension and ERISA issues. He is a member of the American Institute of Certified Public Accountants (AICPA), ABI and the International Women's Insolvency & Restructuring Confederation (IWIRC), and he has contributed several articles on valuation and bankruptcy to the *ABI Journal*. He has also delivered seminars to law firms and has taught business school classes on valuation as a guest lecturer. Mr. Orelowitz received his Bachelor of Commerce with accounting and auditing majors and a Bachelor of Accounting Science with honors from the University of South Africa, and his M.B.A. with high honors from Boston University.

Hon. Karen B. Owens is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington. Prior to her appointment, she was a director in the Bankruptcy and Insolvency group of Ashby & Geddes, P.A., where she maintained a diverse practice, representing corporate debtors, estate professionals, various secured and unsecured creditor constituencies, and other interested parties in reorganization and liquidation proceedings and bankruptcy-related litigation. Prior to joining Ashby & Geddes, Judge Owens started her career at Skadden, Arps, Slate, Meagher & Flom as a corporate restructuring associate, and later went on to clerk for Hon. Brendan Linehan Shannon of the U.S. Bankruptcy Court for the District of Delaware. She is an adjunct professor in the Bankruptcy LL.M. Program at St. John's University School of Law in New York, co-president of the Delaware Bankruptcy American Inn of Court, a member of the board of directors of the Philadelphia/Wilmington Chapter of the Turnaround Management Association, and a member of the International Women's Insolvency & Restructuring Confederation. Judge Owens received her Bachelor's degree from Pennsylvania State University, where she was Phi Beta Kappa, and her J.D. *summa cum laude* from American University's Washington College of Law, where she served as an associate managing editor for the *American University Law Review* and as legal intern to Hon. Stephen S. Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia.