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2021 Outlook

by Christopher Patalinghug

Last month, we looked back at the events that shaped the restructuring industry in 2020, which was made unique because of the COVID-19 pandemic. This month, we look ahead. How will this year's restructuring activity compare to prior years? Which sectors will see the most activity? What will be the greatest challenges? We ask these restructuring experts for their insights on the upcoming year: the **Hon. Melanie L. Cyganowski** (Ret.), E.D.N.Y. Chief Bankruptcy Judge and now Chair of the Restructuring Department at Otterbourg P.C.; Kirkland & Ellis restructuring partners **Aparna Yenamandra** and **Ryan Blaine Bennett**; **Jonathan Carson** and **Eric Kurtzman**, Co-CEOs of bankruptcy administration and technology

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Upcoming Decisions Seen to Provide Clarity, Guidance

by Jeffrey S. Sabin and Carol Weiner Levy

Almost 15 years ago, new shale and fracking technology opened areas like North Dakota and Appalachia to significant oil and gas exploration and development, but the advances also created the need for construction of pipelines and related facilities (e.g., gathering, storage, and/or transportation systems) to ensure that oil and gas could be moved economically by interstate transport to markets vital to the U.S. economy. By then, the Federal Power Act of 1938 and the Natural Gas Act of 1938 had appointed the Federal Energy Regulatory Commission (and its predecessor, the Federal Power Commission) to serve as the regulator and protector

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firm Stretto; **Morris S. Bauer** and **Melissa A. Peña**, Members at Norris McLaughlin; **Allen Wilen**, the National Director of EisnerAmper's Financial Advisory Services Group; **Kate McGlynn** and **David Orlofsky**, Managing Directors at AlixPartners' Turnaround & Restructuring Practice; **Dan Dooley**, Principal and CEO at MorrisAnderson; and **Paul Leake**, global head of corporate restructuring practice at Skadden, Arps, Slate, Meagher & Flom LLP, and partners **Shana Elberg**, **Lisa Laukitis** and **Christine Okike**.

Fitch Ratings has projected a "multiyear period of elevated US institutional term loan and high-yield bond default risk" as the impact of the pandemic continues to be felt on the economy. Which sectors will see activity or challenge in 2021?

Ryan Blaine Bennett, Kirkland: I think sectors that have extremely high overhead costs—for example, travel—will experience significant activity in 2021. For companies in the travel sector, it's not enough for the pandemic restrictions to lift; there will be a significant period of time post-pandemic to ramp back up to normal business levels if those ever fully return.

While we expect most commercial activity to return to normal, certain industries may have permanently evolved during COVID and it remains to be seen how those changes will impact particular business segments within those industries. Film studios, for example, are now bypassing cinemas and direct streaming first-release content to customers. And, of course, the now prolific use of video-conferencing for meetings, interviews and even court hearings, and the extent to which that may impact corporate travel or other related industries.

Morris S. Bauer and **Melissa A. Peña**, **Norris McLaughlin:** Retail; hospitality, including hotels and restaurants; office real estate; higher education; healthcare; and small businesses of almost every type.

Allen Wilen, EisnerAmper: The healthcare, non-profit, retail, hospitality, and commercial real estate industries will continue to see greater restructuring activity in 2021. I do not think we will see significant defaults in large corporate debt in 2021; however, lower middle market corporate debt borrowing will see more defaults. We are also likely to see increased default risk in nonprofit bond debt, such as that in hospitals. For other sectors, until the economy recovers, the low interest rate environment will make the ability to refinance outstanding debt much easier.

Dan Dooley, MorrisAnderson: Restaurants, hotels, retail, travel, aerospace.

Shana Elberg, Skadden: We believe leisure, travel, hospitality, tourism, energy, and brick-and-mortar retail will continue to face challenges in 2021. The sectors that will see the most activity and/or challenges in 2021, however, will ultimately depend on certain key variables, such as the level of government stimulus (and which industries are selected, e.g., hospitals), efficacy of the COVID vaccine, whether there are further rounds of stay-at-home orders, and the pace of economic recovery.

There may also be sectors that see activity in 2021 that may not seem vulnerable today. Many companies across all sectors put a huge amount of debt on their balance sheets to extend their liquidity runaway. Notably, Fitch Ratings projected 7% to 8% of leveraged loans will default by the end of 2021 (compared to just 1.8% in 2019). Ed Altman, the finance professor known for inventing the Z-score (a formula that predicts corporate bankruptcies), also recently predicted a wave of corporate defaults in 2021 based on the ratio of nonfinancial corporate debt to GDP, which spiked to an all-time high in 2020.

Do you see sectors that are bound for consolidation (mergers, acquisitions) in the near term?

Bennett: There has been a growing trend over the last year or so of major landlords buying up significant equity in retailers and I think we can definitely expect to see more of those. We may also see consolidation in industries that have extremely high overhead costs and compete over the same customer base—for example, airlines and cruise-lines are good candidates for merger and consolidation activities.

Bauer/Peña: Prior to the pandemic, the healthcare industry was

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already consolidating. The pandemic has accelerated these mergers and acquisitions. Hospitals have seen a revenue reduction as elective surgeries were placed on hold. The large financially sound healthcare networks will continue to acquire the smaller community hospitals as well as the many standalone doctor groups.

Retail and brand names will continue to merge or be acquired. Many forget that Macy's Inc. (originally Federated Department Stores) is a conglomerate of many retail chains, Macy's, Bloomingdales and others. Many brand names have passed through bankruptcy, including Ray-Ban, Rubbermaid, etc. The names survive and are reinvented by new owners. Although not characterized as a merger or acquisition, the results when the name is put to use is the same.

Wilen: Healthcare, commercial real estate, hospitality and technology will see more consolidation. In the near term, the real growth for middle market companies will not be organic, it will come through acquisition.

Dooley: Aerospace will see lots of consolidation

Christine Okike, Skadden: We expect to see continued consolidation in the energy sector in 2021. The pace of mergers and acquisitions accelerated after the pandemic sent crude oil prices to historic lows in April. Some of the more notable deals this year are Chevron's $13 billion acquisition of Noble Energy, ConocoPhillips' $9.7 billion acquisition of Concho Resources, and Devon Energy and WPX Energy's announced $2.56 billion "merger of equals." Most of the acquisition activity has involved companies with reasonable debt loads. Energy companies with challenged balance sheets generally have been left to weather the pandemic on their own, resulting in a number of high-profile bankruptcies. Continued consolidation in the industry is expected given the need to cut costs to combat low oil prices.

Any case or cases to watch in 2021?

Hon. Melanie L. Cyganowski (Ret.), Otterbourg: Attorneys involved in restructuring will be keeping their eyes on how courts interpret and apply Subchapter V of the Bankruptcy Code. Subchapter V went into effect in the spring of 2020. It has become an important tool for helping small businesses restructure during the COVID crisis—Congress recognized this and, as part of the CARES Act made Subchapter V temporarily available to more debtors. Practitioners on both sides of the table are actively exploring how the new law will impact their clients. Many see the new law, with a dearth of case law, as an opportunity to be creative with their advocacy. The result will be trailblazing cases that will likely end up shaping practice under Subchapter V for years to come.

Bennett: There will be a lot of interesting cases to watch in 2021—in particular, I think everyone's waiting to see what happens in the movie theater, retail, and hospitality industries.

Bauer/Peña: The appeal of the Bankruptcy Court's decision in *In re: Ultra Petroleum Corp., et al.*, No. 16-3272, 2020 WL 6276712 (Bankr. S.D. Tex. Oct. 26, 2020) is one to watch. The case arises from unique facts as the rise of commodity prices resulted in the debtor, a developer of natural gas reserves, being rendered solvent after it filed for Chapter 11 relief. In order for the debtor's equity interest holders to retain any value, the debtor's plan had to provide for all creditor claims to be paid in full. The plan provided that the noteholders would be paid postpetition interest at the federal judgment rate (in lieu of the contract rate) and did not provide for the payment of a make-whole premium. The noteholders argued that they were impaired under the plan. The bankruptcy court agreed.

Thereafter, on appeal, the Fifth Circuit found that a class of claims is impaired under a plan only if the plan—as opposed to the Bankruptcy Code—alters their legal or contractual rights. As a result, the Fifth Circuit remanded to the Bankruptcy Court the following issues: (i) whether the make-whole premiums are allowable under the Bankruptcy Code or disallowed as a claim for unmatured interest under Section 502(b) of the Bankruptcy Code; and (ii) whether the debtors were required to pay postpetition interest at the contract default rate.

On October 26, 2020, the Bankruptcy Court for the Southern District of Texas found that (a)

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make-whole provisions are allowable under the Bankruptcy Code; and (b) a solvent debtor must pay postpetition interest at the contract (rather than the Federal judgment rate) under the Bankruptcy Code. As such, under the bankruptcy court's decision, because the Bankruptcy Code afforded the noteholders the right to the make whole premium and default interest at the contract rate, the debtor's plan impaired their claims. The debtors appealed such decision.

It will be interesting to see whether the district court and then, potentially, the Fifth Circuit determine whether make-whole premiums are allowed under the Bankruptcy Code.

On February 19, 2020, the Small Business Reorganization Act (SBRA), which added a new subchapter to the Bankruptcy Code, became effective. Commonly referred to as Subchapter V, the SBRA was enacted in an effort to reduce the cost and expense for small businesses to reorganize under Chapter 11. The CARES Act increased its application to those cases with debt of no more than $7.5 million.

Small businesses are the largest employer in this country. As of this date, approximately 1,000 Subchapter V cases have been filed nationally. We remain in a wait-and-see position as to how this tool will play a role in the survival of small businesses. With the votes of acceptance from creditors not being required, reorganization will be dependent on the court finding a proposed plan of reorganization and the debtor's business plan to be feasible. The case law that is developed for determining "feasibility" parameters will have a significant impact on the outcome of these cases.

Paul Leake, Skadden: The appeal of the bankruptcy court's decision in *Ultra Petroleum* is worth watching in 2021. On November 30, 2020, the bankruptcy court granted a direct appeal to the Fifth Circuit. One of the issues before the Fifth Circuit—whether a make-whole premium constitutes unmatured interest—could have significant implications on a prospective debtor's optimal filing venue. While in recent years the Second Circuit and Third Circuit have ruled on the enforceability of make-whole premiums in the bankruptcy context, both of those decisions involved issues of contract interpretation—not whether the make-whole premium was disallowed under section 502(b)(2) of the Bankruptcy Code, which disallows claims for unmatured interest. If the Fifth Circuit adopts the bankruptcy court's narrow view of what constitutes "interest," a debtor that owes a make-whole premium to its unsecured creditors may be unable to invoke section 502(b)(2) of the Bankruptcy Code.

What awaits the restructuring services sector (legal, advisory, consultancy etc.) in 2021?

Cyganowski: The restructuring services sector will need to remain responsive to the world around it. In 2020, an expected increase in personal bankruptcies failed to materialize. At the same time, however, the volume of large commercial bankruptcies grew. Whether 2021 is different remains to be seen. Government intervention in finance will likely be a key factor in determining the rate and extent of restructuring in 2021. Many see programs, such as PPP and mortgage forbearance, as having played an important role in staving off widespread defaults during 2020. It is unclear whether and to what degree government intervention will continue in 2021 or whether the programs enacted in 2020 will result in unforeseen consequences. At the same time, we have witnessed an increase in asset valuations coupled with a slight uptick in residential mortgage defaults. All this will impact the restructuring services industry.

Aparna Yenamandra, Kirkland: It is hard to say until the pandemic is truly over but until the pandemic is over and companies have come through stable on the other side, restructuring professionals will continue to be busy. This could take a lot of different forms—restructuring advisors may be tapped to help make operational cutbacks, legal advisors may be brought in to explore in-court or out-of-court restructuring options, investment banks may be hired to help raise money, or all of the above. We've learned a lot in 2020 about how to address the unique difficulties created by the pandemic and those lessons will certainly continue to be valuable in 2021.

Eric Kurtzman, Stretto: Looking back gives us insight into the future

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of our industry. Over the last decade, service providers have developed technology tools that corporate-restructuring professionals readily adopted such as virtual data rooms, case-management software, and real-time public-securities solicitation reports. The continued evolution and adoption of these time-saving tools provides a broader scope of resources that attorneys desire regardless of whether remote working conditions continue or they return to their offices post-pandemic.

As turnaround professionals expect more seamless coordination in terms of their online systems so they can maintain business operations without disruption, Stretto is well-positioned at the center of the bankruptcy ecosystem, serving as that one-stop shop for fiduciaries with a comprehensive suite of services and technology to meet the industry's ever-growing needs.

Bauer/Peña: The state court moratoriums will be lifted. Companies will exhaust the government assistant loans that have kept them afloat. We anticipate an increase in commercial foreclosure actions, landlord/tenant actions and bankruptcy filings.

Subchapter V will be a powerful tool for companies that qualify. We will also likely see an increase in single asset real estate cases as well as consumer bankruptcy filings.

The majority of bankruptcy practitioners are generalist, practicing in all areas of the law and whose bankruptcy experience resides in the mid-market to small company bankruptcies. These practitioners will be very busy by the second quarter of 2021 with consultations, workouts, Chapter 11 filings, Subchapter V cases.

Wilen: For 2021, I see a greater number of lower middle market engagements in the healthcare, nonprofit, hospitality, commercial real estate and estate retail sectors. Much of the rest of corporate America will weather this instability and survive. In the restructuring services sector, I see a lot of movement between firms of senior level professionals as firms actively recruit and endeavor to staff up for likely market opportunities.

Kate McGlynn and **David Orlofsky, AlixPartners:** One of the few positives that has emerged from the pandemic is how working remotely could improve our ability to recruit and retain a diverse group of top talent. Historically, people would either not enter our profession or leave because the extensive travel would impact their personal lives. Working remotely has removed some of those issues and obstacles.

Additionally, the access to low -cost capital will likely continue. The High Yield Bond Index recently reached an all-time low of just under 5% (This should be renamed Higher Yield, because it is no longer High). Interest rates are lower now than pre -pandemic which is just an amazing statistic. Many companies have been able to tap the capital markets to buy time. The challenge for these companies will be to restructure their operations to grow into their balance sheets. Successfully implementing an operational restructuring will be an imperative to many companies' long-term viability.

Dooley: I thought restructuring would be booming in mid to late 2019 and I was wrong. I think it will likely be late Q1 or Q2 before the effect of COVID on loan quality of borrowers starts to bubble up with covenant defaults and workout activity.

Leake: Many questions abound for the restructuring services sector in 2021. Will the capital markets remain frothy and accessible to distressed companies if the pandemic persists? Can companies that levered up their capital structures to gain time to get to the "other side" of the pandemic remain compliant with their debt covenants? Will lenders remain willing to offer covenant relief if the COVID vaccine is not the panacea everyone is hoping for?

Many companies were able to tap the capital markets in 2020 to extend their liquidity runway in hopes of a return to business as usual. But for certain industries, even if the vaccine is a wild success, it is unclear whether there has already been a permanent shift in consumer behavior. Those unaccustomed to shopping online, home cooking, at-home exercise, or conducting depositions using Zoom, were all forced to become intimately familiar with a new way of doing things and may decide to permanently adopt these new practices. ¤