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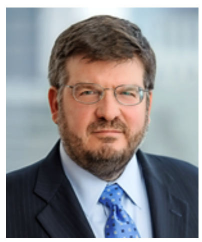
FINANCIAL RESTRUCTURING

Three Skadden attorneys note that while the improved U.S. economy has reduced bankruptcies, several sectors, such as the retail and health-care industries, remain at risk.

State of the Financial Restructuring Market



BY JAY GOFFMAN, PAUL LEAKE, AND MARK CHEHI

Continuing low interest rates and generally improved economic conditions in the U.S. and worldwide during 2017 have reduced financial distress and the need for business bankruptcies in most sectors. However, out-of-court financial restructurings and Chapter 11 bankruptcies will continue in 2018 due to significant market changes in the energy, retail, and health-care industries that have developed over the past several years. While financial restructurings in the energy sector may decrease as oil prices rise, retail business enterprises will remain at risk because of the ongoing fundamental transformation of the retail sector, and uncertainty about the future of the Affordable Care Act (ACA) should contribute to continuing financial stress in the health-care sector.

Meanwhile, according to Federal Reserve Economic Data and the Bank for International Settlements, total credit to nonfinancial corporations is at its highest level relative to U.S. gross domestic product since the 2008 financial crisis—now estimated to be more than 70 percent of the U.S. GDP. If the U.S. economy slows or recedes, interest rates rise markedly or credit markets tighten, the need for corporate debt restructurings may increase.

Political and regulatory changes in the U.S. in 2018 and beyond also may impact restructuring markets.

Energy

The rise and fall of energy prices drives financial outcomes in the energy sector. In early 2016, oil prices plummeted to roughly $30 per barrel, causing severe liquidity problems for many oil and gas companies, particularly those in the exploration and production (E&P) space. E&P companies rely on reserve-based loans to fund their operations, and the reserves that secure their borrowings are subject to periodic revaluations and redeterminations, usually twice a year. In the redetermination process, a lender assigns a value to a company's reserves and adjusts the company's borrowing base accordingly. The spring 2016 round of redeterminations and reserve revaluations reflected declining oil prices, thereby reducing borrowing base availability and liquidity for E&P companies. Accordingly, in 2016 and 2017, numerous E&P companies were forced to use Chapter 11 to shrink their cost structures and address their liquidity shortfalls. E&P-adjacent industries (such as oilfield services, pipeline construction, and offshore drilling and services) also experienced sharp increases in bankruptcy filings.

During the second half of 2016, oil prices rose to over $50 a barrel, and since September 2017 they have rebounded to over $60 a barrel. Accordingly, Chapter 11 filings in the E&P sector and related industries have slowed. In-court and out-of-court financial restructurings in the energy sector will continue, but the oilfield service industry is likely to benefit as reorganized E&P companies emerge from bankruptcy and undertake deferred maintenance and improvement projects. Pipeline construction may increase with improved E&P business activity and recent pro-pipeline policy changes in the U.S. However, a global oversupply of oil continues to pose challenges for certain sectors, and the 2017 trend of bankruptcies by offshore drilling support vessels may continue.

Retail

Retail sector financial restructurings and bankruptcy reorganizations increased significantly in 2016 and 2017, with many high-profile retailer Chapter 11 filings, a trend that is expected to continue. The need for financial restructurings results from the ongoing fundamental transformation of the retail industry:

- increased online sales, including the Amazon effect (according to market research firm Slice Intelligence, Amazon accounted for an estimated 53 percent of all online U.S. retail sales in 2016), which is displacing brick-and-mortar store commerce;
- the success of discount chains;
- changing retail consumer demographics and preferences, especially among millennials; and
- a decrease in retail mall traffic, partially attributable to the continued success and expansion of online retailers.

Large, traditional national retail chain footprints entail cost structures that are difficult to rationalize as the retail industry continues its transformation. In 2017, retailers closed thousands of stores and laid off tens of thousands of workers to cut costs and compete with e-commerce. Announced store closures included 100 by Macy's and 150 by Sears—but the total store closure picture is much larger, with over 8,500 estimated in the U.S. in 2017.

Retail-related sectors such as commercial real estate will continue to be impacted as large retail chains use Chapter 11 to shrink their footprints and the Bankruptcy Code to reject their obligations to landlords under unwanted leases. Retail restructurings leave commercial property owners and managers with excess supply and dwindling demand for their properties.

Legislated state and local hourly wage law increases also pose significant challenges to retail stores, supermarkets, fast food restaurants, and other businesses with operations and financial conditions that depend on unskilled, low-priced labor.

Health Care

Health-care industry bankruptcies have increased as bankruptcy filings across the broader economy have plunged since 2010. Health-care bankruptcy filings more than tripled in 2017, according to data compiled by Bloomberg. Additionally, health-care mergers and acquisitions have noticeably increased in number. From 2013-14 to 2015-16, the number of U.S. distressed health-care M&A transactions increased by more than 85 percent, according to an article in the May 2017 issue of *Journal of Corporate Renewal*. The need for financial restructurings in the health-care sector is expected to continue in 2018 and beyond.

Changes in the ways health care is delivered have increased financial stress in the health-care industry:

- the shift from volume-based to value-based reimbursement schemes;
- payer-led demand for less costly outpatient (rather than inpatient) procedures;
- the increased need for equipment and technology investments; and
- heightened competition among competitors, particularly in rural hospitals and senior assisted living facilities.

Continuing uncertainty about the future of the ACA (see *As Congress Struggles With ACA Repeal, Trump Administration Moves Forward With Regulatory Reform*) also contributes to health-care industry distress and is an important factor in health-care workouts, restructurings, and transactions. This uncertainty has caused some insurers to increase their premiums or exit ACA insurance exchanges. The number of uninsured patients may rise as premiums increase and patients have fewer insurance options, and a spike in uninsured patients may impose further financial pressure on health-care providers. For instance, many private rural hospitals that now receive reduced payments under the ACA must nevertheless provide care to large numbers of poor and uninsured patients. The recent tax legislative elimination of the individual mandate that requires most Americans to have health insurance or pay a penalty may lead to a significant increase in the uninsured population that must be cared for by hospitals already in financial distress.

Political and Regulatory Impacts

Recent and potential U.S. political and regulatory changes may impact restructuring markets in certain industries. The Trump administration has adopted a pro-pipeline stance that may improve market conditions for oilfield service and pipeline industries. Also, the Trump administration has expressed its intention to repeal or alter some provisions of the Dodd-Frank Act. The act provides for the reorganization of failing banks and other financial institutions, and repeal or amendment of it may change the restructuring landscape for financial institutions. Federal Reserve policies and actions that increase interest rates will influence availability of credit.

Perhaps most significant are the recent reforms and changes to the U.S. tax code. (See *US Tax Reform Enacts the Most Comprehensive Changes in Three Decades*). The major reduction in the U.S. corporate tax rate may drive increased economic activity in numerous sectors and result in repatriation into the U.S. of significant capital. Such developments may result in significant general economic growth that leads to inflationary pressures and higher interest rates, which tend to increase the need for corporate restructuring activity in certain sectors.

Author Information

Jay Goffman is global co-head of Skadden, Arps, Slate, Meagher & Flom LLP's Corporate Restructuring Group. He is recognized as a worldwide leader in restructuring, noted as a pioneer in the use of prepackaged restructurings, and has received numerous awards and honors over the course of his career, including being named a ''Dealmaker of the Year'' by The American

Lawyer, one of The National Law Journal's ''Lawyers of the Decade'', one of the Most Innovative Lawyers in the U.S. by the Financial Times and several Lifetime Achievement Awards.

Paul Leake is global co-head of Skadden's Corporate Restructuring Group. He represents a wide range of clients in all forms of corporate restructurings in industries such as retail, shipping, mining, airlines, energy, health care, publishing, satellite communications and real estate. He has published and lectured extensively on U.S. and transnational insolvency matters. He is listed among the leading restructuring lawyers in *Chambers USA* and Chambers Global and was selected as an Outstanding Restructuring Lawyer for 2016 by *Turnarounds & Workouts*.

Mark Chehi is a Corporate Restructuring partner at Skadden where he has represented numerous public and private companies in out-of-court restructurings and workouts, ″prepackaged″ and prearranged bankruptcies, traditional Chapter 11 cases, and related transactions, strategy and governance issues. He was recognized as Best Lawyers' 2016 ″Lawyer of the Year for Bankruptcy and Creditor Debtor Rights / Insolvency and Reorganization Law″ and has been listed as a leading restructuring lawyer in *Chambers USA*.

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