Testimony before the ABI Chapter 11 Reform Commission

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My name is J. Scott Victor. I am a Founding Member and Managing Director of SSG Capital Advisors, LLC, a boutique special situation investment banking practice and member firm of FINRA and SIPC. I am a Fellow of the American College of Bankruptcy and serve on the Board of Directors of both the American Bankruptcy Institute and the Turnaround Management Association. I have spent nearly three decades in both the practice of bankruptcy law and in special situation investment banking and have testified as an expert witness in bankruptcy courts throughout the United States. It is an honor to have the opportunity to share my personal views and I thank the ABI Commission for the privilege to testify today regarding the important issue of Chapter 11 practice and reform.

SSG's clients have included publicly traded, privately held, private equity sponsored and family owned companies across a wide spectrum of industries. I have spent my entire career in the mid to lower middle market advising companies facing generational, shareholder, operational, financial, legal and regulatory challenges, affectionately known as *special situations*. These special situations often have little in common with the challenges faced by mega corporations and require strategic application of a complex bankruptcy code to achieve the highest value for stakeholders. My extensive experience with middle market client transactions has shaped a rather contrarian view of the Commission's goals and the need for Chapter 11 reforms.

The stated purpose of the Commission is:

> *In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders.*

It is the last phrase that I want to focus on today- *"…the attendant preservation and expansions of jobs and the maximization and realization of asset values for all creditors and stakeholders."* That phrase is what special situation investment banking is all about. Our role in each and every assignment, whether out of court or in a Chapter 11 case is to preserve jobs and maximize value.

The value maximization and job preservation in a Chapter 11 case may come in the form of a debt refinancing and/or equity restructuring or sale. The universal first choice of any troubled borrower is debt refinancing as this approach fully preserves equity. But that happens outside of a Chapter 11 and only when the credit markets are relatively liquid as they are today.

Any restructuring professional in the mid to lower middle market knows that debt refinancing and debt and/or equity restructurings in a Chapter 11 case are pretty rare. In fact, debt for equity conversions now usually happen in the context of a credit bid in a § 363 sale. So what is wrong with that? In my view -- nothing. Section 363 sales have become the most common vehicle for Chapter 11 cases where equity control passes to another party.

The original drafters of the 1978 Act, some of whom are on this Commission, may have envisioned how § 363 would be used to sell going concern businesses for companies of all sizes, but I certainly did not when I started practicing bankruptcy law in Philadelphia in 1983. I spent the 4th of July holiday weekend in 1984 writing the brief opposing the § 363 sale of Abbotts Dairies to Johanna Farms - one of the seminal cases authorizing a § 363 sale for a going concern business rather than through a plan of reorganization.

Many experienced practitioners in our industry may think that § 363 sales have gone too far. Some may wax nostalgic for the debtor reorganizations, restructurings, and rehabilitations required under a plan of reorganization prior to the 1978 Act and the norm in the first 10-15 years of the current Bankruptcy Code. I would argue that the overwhelming prevalence of § 363 sales since the late 1990s and early 2000s has been the direct result of good lawyering, market sophistication and efficiency.

Prior to the late 1990s there were few private equity funds and even fewer interested in troubled companies, especially those in the mid to lower middle market. The private equity funds that focused on special situation and opportunistic acquisitions sprang up in the late 1990s and early 2000s along with hedge funds looking for distressed debt opportunities. Today, there are scores of distressed-focused private equity and hedge funds with interests ranging from the lowest end of the market to the large cap opportunities and everything in between. There is no real difference now in the strategies and techniques used by both distressed-focused private equity funds and hedge funds -- that is, control the fulcrum security to control the company. The market is both sophisticated and efficient. The strategic buyers of troubled companies are similarly sophisticated and not in any way squeamish about participating in § 363 sales.

I strongly believe that it's the market sophistication and efficiency- primarily through § 363 sales that preserve jobs and maximize value. In fact, I think the first sentence of the Commission's purpose – *"In light of the expansion of the use of secured credit, the growth of* *distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code"* is not entirely correct. Rather, it's the expansion and use of secured credit and the growth of distressed debt markets, through the distressed-focused private equity and hedge funds that have preserved jobs and maximized the value of distressed assets.

This is particularly true in the mid to lower middle market. I can tell you from firsthand experience that at the height of the great recession in 2008, we had great trouble selling smaller companies because the credit market shut down. Without access to credit, no one wanted to buy smaller distressed companies. The result was more liquidations of smaller companies than at any time in my career. It's commonly understood that liquidations are the worst possible outcome for the distressed companies and their employees and often have devastating effects on the supply chain and surrounding community.

In my view, the greatest protection for jobs in distressed companies is vibrant credit and distressed debt markets. In order for those markets to be vibrant it is essential that several components of § 363 sales are preserved and strengthened, including:

- Section 503(b)(9) protections should be abolished to minimize the challenges to § 363 sales posed by increased carve-out requirements from secured lenders;
- Job preservation as a consideration of what is higher and better should be codified to ensure that appropriate value is assigned to all bids;
- Sales free and clear should be clarified and codified to provide consistency among the bankruptcy courts for proposed asset sales where the secured lenders are under-secured and proceeds are insufficient to satisfy the claims;

- Stalking horse buyer and statutory bid protections should be codified and made uniform to eliminate inefficient platform bid negotiations with parties constantly seeking above-market protections.

I have respectfully clashed with some bankruptcy judges who don't consider the significance of job preservation when determining the highest and best value. Successful § 363 sales not only preserve jobs but can produce buyers willing to revive idle plants and stimulate job development in economically challenged communities. The ability to conduct § 363 sales should not be subject to timing delays and tactics required by plans of reorganization or liquidation which serve only to increase expense and further jeopardize a debtor's cash reserves. The implementation of these critical revisions would have an immediate positive effect on the bankruptcy process and the creation of value for all stakeholders.

I believe that the four (4) keys to the Bankruptcy Reform Act of 1978 and the brilliance of its structure and intent are the:

1. Reorganization, rehabilitation and sale of distressed businesses;
2. Preservation of going concern values;
3. Job preservation; and
4. Avoidance of liquidation.

These four keys must remain as the bedrock of any future bankruptcy legislation – whether by way of new amendments, repeal of some of the 2005 BAPCPA amendments or by way of a new Act. Bankruptcy legislation must provide- as the Act of 1978, did- effective, efficient and expeditious proceedings. Those goals and objectives as well as facilitating vibrant credit and distressed debt markets can best be accomplished by retaining and strengthening § 363 sales.

In summary, in my opinion, the minor clarification and codification of § 363 sales will have a positive effect on the US bankruptcy process by enabling many debtors to successfully reorganize, preserve jobs and maximize value for all stakeholders, especially in the mid to lower middle market. I appreciate the Turnaround Management Association and ABI Executive Director, Samuel J. Gerdano for coordinating today's field hearing and once again thank the Commission and the ABI for the opportunity to provide an unorthodox perspective on these important issues.