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The Rise of Special Situations

By Doug Mintz and Adam Harris

The restructuring world has seen massive landscape shifts since 2008. These have necessitated significant changes in how lawyers and law firms approach the restructuring practice in the last decade — mandating ever-closer coordination and collaboration between bankruptcy experts, finance partners, litigators and the capital markets team. This enables lawyers to bring their clients a broad-based approach to resolving problems where the solutions are not as simple as they once were.

Factors Driving Change

The United States enacted the U.S. Bankruptcy Code in 1978. Subsequently, bankruptcy filings rose virtually every year through their peak in 2005; they then declined in the mid-2000s before reaching a slightly lower post-2008 peak in 2010. Bill Fay, *Bankruptcy Statistics*, DEBT.ORG (July 20, 2023). Subsequently, bankruptcy filings have declined nearly every year through 2022 — reaching levels last seen in the very early days of the Bankruptcy Code in the early 1980s. *Id*. The number of filings is slated to rise a modest 10%-15% off these historic lows in 2023. *Bankruptcy Filings Rise 13 Percent*, U.S. COURTS (Oct. 26, 2023). In short, bankruptcy rates have fallen in a broad trend for nearly the entire last two decades.

Not coincidentally, interest rates largely peaked in the early 1980s and have fallen to virtually rock-bottom rates for most of the last 15 years before turning up more recently. Federal Funds rates peaked at nearly 20% in the early 1980s — right after the birth of the Bankruptcy Code. They declined generally for the next 28 years — before cratering to near zero in the aftermath of 2008. Those rock-bottom rates remained in place for nearly the next decade — and returned in 2020 before rising significantly over the last two years. *Federal Funds Effective Rate [FEDFUNDS]*, FRED, FED. RES. BANK OF ST. LOUIS (last visited Dec. 11, 2023).

And — also not coincidentally — private capital has come to dominate the finance (and restructuring) world. In the 21st century, private equity has grown assets under management from less than $1 trillion in 2000 to nearly $8 trillion in 2022. Charles McGrath, *Dry Powder Attempts to Keep Up with Pricey Deal Markets*, PREQIN (Nov. 21, 2022). And the public equity markets have receded from view with the number of publicly listed companies in the U.S. peaking in the late 1990s around 8,000, and reducing by half over the last 25 years. Timothy L. O'Brien, *et al.*, *Where Have All the Public Companies Gone?*, BLOOMBERG (Apr. 9, 2018).

Private debt has followed a

similar, if later, trajectory. Preqin estimates private debt assets under management grew from around $300 billion in 2010 to about $1.5 trillion in 2022. Marc Rubinstein, *Private Lending*, NET INTEREST (Nov. 3, 2023). Earlier this year, the *Wall Street Journal* reported that the $1.5 trillion private debt under management exceeds the leveraged loan market — the long-time source of debt capital for middle-market corporate borrowers — for the first time. Jodi Xu Klein, *The $1.5 Trillion Private-Credit Market Faces Challenges*, WALL ST. J. (Oct. 16, 2023).

Why Private Markets?

Many private capital providers — both debt and equity — emphasize "speed of execution" and efficiency. As S&P notes, "private debt remains very relationship-driven," meaning "borrowers work more directly with lenders," and deals can accordingly "be executed more quickly, and with more certainty of pricing." Evan Gunter, *et al.*, *Private Debt: A Lesser-Known Corner of Finance Finds the Spotlight*, S&P GLOBAL (Oct. 21, 2021).

This comes at a time when traditional capital sources (*i.e.*, banks) have faced greater regulatory scrutiny in the wake of Dodd-Frank and other post-2008 regulatory reforms. *See Today's Increasing Regulatory Scrutiny Requires Portfolio Compliance Vigilance*, WOLTERS KLUWER (Aug. 9, 2023).

As banks have reduced lending, private capital providers have stepped in to fill the void. *See* Jamie Weinstein, *et al.*, *Opportunities in Private Credit: Stepping In as Banks Step Out*, PIMCO (Nov. 11, 2023).

Those private credit providers assert that the growth in private capital can lead to "more efficient workouts — and potentially greater recovery — in case of default, compared to publicly syndicated debt placements that feature multiple lenders with competing priorities." *Understanding Private Credit*, GOLDMAN SACHS (Oct. 20, 2022). 2023).

A Time to Change

These factors have led to many changes in the way restructuring takes place. Not only are bankruptcies falling — but free-fall bankruptcies have decreased in frequency over the history of the Bankruptcy Code. According to the LoPucki Bankruptcy Research Database, in the early 1980s, free-fall bankruptcies made up nearly all cases detailed in the database. FLORIDA-UCLA-LOPUCKI BANKR. RSCH. DATABASE (last visited Dec. 11, 2023). In the 2010s, the LoPucki database tends to show about 50% of cases in the database constituting free-fall bankruptcies with around 50% constituting a combination of pre-negotiated and prepackaged bankruptcies. *Id*.

And so, the world has changed for folks in the restructuring business. While supporting data is scarce, we speak from a combined nearly 60 years of experience. Creditor-side restructuring is much different than 20-30 years ago (or even 10 years ago). Where, many years ago, we would have received a call from a lender (almost always a bank) noting that it faced trouble with a loan that might file for bankruptcy in the next few weeks and needed help, today someone might place a call a year — or more — in advance. And that call is as likely to come from a lawyer to the lender as vice versa.

On a typical call, the lender might be scrutinizing an array of options for a loan not yet near maturity — or even active distress or default. While these options might end

with bankruptcy, they likely begin with amendments, recapitalization and other liability management exercises that would not require the help or scrutiny of a bankruptcy court. Bankruptcy may well remain an option, but, typically, an option for implementing consensual restructurings that can be implemented through a prepackaged or pre-negotiated plan — or as a means to deal with intransigent holdouts to an otherwise largely consensual plan.

In the meantime, subsets of creditors are scrambling with one another to maximize their position — and potentially to put the significant amount of "dry powder" in private capital market to work. *See*, *e.g.*, Dylan Thomas & Annie Sabater, *Private Equity Dry Powder Swells to Record High Amid Sluggish Dealmaking*, S&P GLOBAL (July 20, 2023); Kat Hidalgo & Carmen Arroyo, *Private Debt Funds Have a $500 Billion Conundrum: Credit Weekly*, BLOOMBERG (Oct. 28, 2023). All of this potentially comes at a cost to the capital providers who face stiff competition.

At Schulte Roth & Zabel, our firm is focused on private capital providers, and we represent many funds that take the lead on making and restructuring private loans. Working with our clients, we have seen these trends firsthand. This led us, in September 2023, to launch our "Special Situations" team with a focus much broader than our historical bankruptcy mandate. While we have always collaborated on distressed situations, we are now attacking them up front with the full spectrum of Schulte's offerings in a coordinated fashion from day one. This ensures clients get the array of potential solutions they need at the outset of a potentially long and complex restructuring. We work with partners from our finance, litigation, capital markets, M&A and many other teams to put together the solutions clients need at a time when the world of restructuring has undergone major transformation.

This is the Special Situations solution the market demands today and that we are helping fill. ¤

About the Authors

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