# Trends And Opportunities In Distressed M&A Investing

By **Aaron Rigby and Charles Persons** (November 26, 2019)

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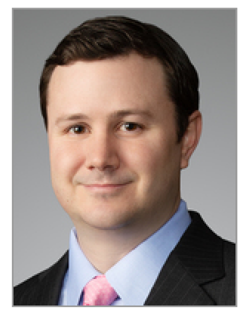

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With relatively inexpensive capital available to investors through low interest rates and excess "dry powder" in the marketplace and an M&A market that has become increasingly competitive, potential investors and deal professionals are willing — and some are in fact actively looking — to engage in transactions involving underperforming and insolvent assets in an effort to maximize returns in this difficult market.

The opportunities to engage in those types of transactions are increasing as well, with S&P recently reporting that the U.S. distress ratio had widened to 8.5% as of Oct. 15, up from 7.6% on Sept. 16.

As a result, it is expected that M&A activity involving distressed or insolvent companies may increase in the coming year (especially in certain industries), and as 2019 comes to a close, it may be helpful to consider some of the past year's distressed M&A developments and trends, including how the market may evolve in the coming year.

**Industries Poised for Increased Distressed M&A Activity**

In addition to generally analyzing traditional indications of financial distress in a company (i.e., negative cash flow, overleveraged assets, etc.), investors are increasingly proactive in assessing market trends and changing industry dynamics to monitor indications of distress in certain companies or industries. With name brands like Payless ShoeSource Inc. and Brookstone (among many others) seeking Chapter 11 protection in the past 18-24 months, the retail industry has dominated much of the restructuring headlines recently.

However, other companies or industries whose growth and profitability are vulnerable to relatively rapid changes in consumer preferences and spending, such as travel, entertainment and health care, may also see increased distressed M&A activity in the coming year.

Additionally, although M&A activity among distressed assets in the energy sector has slowly declined since the significant drop in crude oil prices in 2015, the market has seen an uptick in bankruptcies of oil and gas producers in 2019. There have been 33 Chapter 11 filings of such companies through Sept. 30, which exceeds the 28 producer bankruptcies for the entirety of 2018.[1]

Many of the current oil and gas bankruptcies are not the result of sharp declines in crude prices (as was the primary driver of oil and gas filings in 2015 and 2016) but instead the product of upcoming debt maturities by overleveraged drillers that took on debt to finance production growth, betting that higher oil prices (which have still not occurred) would sustain operations and service their debt obligations.[2]

As a result, it is anticipated that distressed activity in the market will increase in the coming year as debt obligations mature and new investments slow, especially among gas-focused producers where investor interest appears to be waning for shale companies. Further, recent concerns of oversupply of oil reserves may create volatility in crude oil prices, which have been relatively constant for the past year, adding to the possibility of an increase in distressed oil and gas assets coming to market.

Uncertainty in what seems like a constantly changing outlook on the status of long-term tariffs and related trade restrictions also has the potential for a significant near-term impact on industries that rely on import/export cost structures (i.e., U.S. and foreign manufacturing and agriculture among others), as well as potential changes in a major election year, further add to a general insecurity regarding larger vulnerabilities in the U.S. economy as a whole.

**Buyers of Certain Consumer-Facing Businesses Can Purchase Free and Clear of Consumer Claims**

While participants in an active distressed M&A market are often faced with a more scrutinized process when engaging in opportunities in certain types of consumer-facing businesses, one recent case highlights the value that buyers may be able to unlock by acquiring consumer businesses through a Chapter 11 plan free and clear of consumer claims.

New Residential Investment Corp., or NRZ, recently completed the acquisition of certain residential mortgage servicing rights and related assets from Ditech Holding Corp. and Ditech Financial LLC. When NRZ announced in October the closing of its acquisition, including its forward Fannie Mae, Ginnie Mae and nonagency mortgage servicing rights that collectively had an aggregate unpaid principal balance of approximately $62 billion as of Aug. 31, it completed a particularly complex in-court restructuring of Ditech's assets that started in February when Ditech filed for Chapter 11 protection.[3]

NRZ signed a "stalking horse" purchase agreement for Ditech's forward mortgage business in June and was announced as the successful bidder for those assets in July.

In its attempt to gain approval for a Chapter 11 plan that included the sale of Ditech's forward mortgage business to NRZ "free and clear" of legal claims and certain preclosing liabilities (as is permitted by the Bankruptcy Code and customary for in-court restructurings), Ditech's Chapter 11 plan faced strong opposition from consumer creditors, including a formal Consumer Creditors Committee organized to review (and ultimately object to) Ditech's initial proposed Chapter 11 plan, the U.S. Trustee's Office (the division of the U.S. Department of Justice that oversees bankruptcies), attorneys general from approximately a dozen states and a court-appointed consumer protection ombudsman.

Each argued (among other things) that Ditech's initial proposed plan would not sufficiently protect consumers in instances of mortgage overpayments or fraud or misconduct on the part of the mortgage servicer.[4]

Ditech ultimately settled the consumer-related objections (including those from the Consumer Creditors Committee and the U.S. Trustee's Office), which cleared the path for court approval of its Chapter 11 plan and sale to NRZ.

In doing so, Ditech agreed to amend its plan to address certain of the consumer-related objections, including (1) creating a $10 million fund to be set aside from the transaction proceeds to pay consumer claims, and, more importantly, appoint an independent consumer protection representative to oversee the administration of post-bankruptcy consumer claims and payments from the fund, and (2) providing a post-sale process that allows consumers the ability to contest account statements, as well as requiring Ditech to continue to investigate alleged account errors in consumer accounts after the sale to NRZ.[5]

One takeaway from Ditech's Chapter 11 process is the possibility of increased scrutiny of certain restructuring plans, including in consumer-facing businesses. As more and more investors become knowledgeable in this particular type of investing and processes related to distressed investing, debtors and purchasers have experienced additional difficulties getting their preferred plans across the finish line.

Existing secured lenders have long held significant leverage in these types of transactions, but as more parties have become comfortable in this space, the potential for disruptive third parties to force plan proponents to readjust mid-case has increased. Add to this the additional complexities that can come from aggressive unsecured creditors' committees and governmental agencies (including the possibility of a statutory committee charged with representing consumers' rights as in Ditech), layer in the public nature and judicial oversight associated with the Chapter 11 process, and it's easy to see why potential acquirers and targets may still be wary of using courts to complete their preferred transactions.

However, a significantly more important takeaway from the Ditech case is that savvy purchasers have been able to engineer and execute strategies to capture the key benefits of a Chapter 11 sale process, notwithstanding the increased scrutiny from creditors, governmental actors and other parties. NRZ purchased Ditech's forward mortgage servicing and origination assets free and clear of consumer claims by completing the transactions through a full Chapter 11 plan process, as opposed to a Section 363 sale process.

The complicating factor in Ditech was the statutory hurdle presented by Section 363(o) of the Bankruptcy Code. Section 363(o) is an exception to the ability of a purchaser to acquire assets free and clear of claims. In particular, it provides that, in the case of an acquisition of an interest in a consumer credit transaction (within the meaning of Section 363(o)) in a Section 363 sale, consumers retain their claims and defenses to the same extent as in a nonbankruptcy sale.

In other words, the buyer cannot buy those assets free and clear of consumer claims. After extensive litigation, the court sided with NRZ and held that the transacting parties' preferred strategy — acquisition of the mortgage assets under a plan sale free and clear of most consumer claims — was permissible under the

Bankruptcy Code. As a consequence, a purchaser of interests in a consumer credit transaction (within the meaning of Section 363(o)) may avoid assuming consumer claims by completing the deal under a plan, where creditor protections and due process considerations are considered greater because of the plan voting process and the many requirements of Section 1129.

By purchasing the assets under a plan, NRZ and the debtors avoided leaving consumers without any recourse. Instead, the burden of reconciling, defending and funding consumer claims was shifted from the purchaser (which would have had to assume the consumer claims under a Section 363 sale) to the debtors' remaining estate. The debtors were required to prove up their best-interests-of-creditors case (Section 1129(a)(7)) by demonstrating, through their liquidation analysis, that the $10 million settlement with the Consumer Creditors Committee was equal to or greater than the recovery that consumers would receive on account of their claims in a Chapter 7 liquidation.

In ultimately obtaining the judicial approval to confirm the plan, the purchaser was able to successfully manage what it perceived to be a material downside risk related to the consumer claims — i.e., the potentially significant burden of time and costs associated with defending consumer claims and potential class actions related to preclosing conduct of Ditech.

**Conclusion**

As the market shows increased signs of volatility and the number of distressed assets rises, it is important for traditional financial and strategic investors to understand and consider how to put their capital to use in the distressed space. However, engaging in this type of process need not necessarily be viewed in a negative light. By understanding the "art of the possible," investors may find that it is in fact preferable to undertake certain M&A transactions by working within, rather than running from, the unique opportunities afforded by the Chapter 11 process.

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***Disclosure: Rigby and Persons were part of the team representing NRZ in its acquisition of assets from Ditech.***



[1] https://www.haynesboone.com/-/media/files/energy_bankruptcy_reports/oil_patch_bankruptcy_monitor.ashx?la=en&hash=D2114D98614039A2D2D5A43A61146B13387AA3AE.

[2] https://www.wsj.com/articles/oil-and-gas-bankruptcies-grow-as-investors-lose-appetite-for-shale-11567157401.

[3] https://www.businesswire.com/news/home/20191002005438/en/New-Residential-Investment-Corp.-Completes-Acquisition-Select.

[4] https://www.bloomberg.com/news/articles/2019-08-28/ditech-can-t-sell-mortgage-businesses-without-homeowner-claims.

[5] https://www.law360.com/articles/1201743/ditech-says-new-ch-11-plan-protects-consumer-creditors.

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