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Business Restructuring and Insolvency Alert
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Future-proofing your industrial business: optimize your corporate structure now to minimize problems in the future

Industrial and manufacturing businesses face all kinds of challenges: pricing and competitive pressures; regulatory demands; cross-border trade regulations and obligations; and litigation risk stemming from environmental and tort claims. These challenges create risks around every corner, some even rising to the level of "bet-the-company" issues – the things that keep GCs up at night.

One approach is to simply address issues as they arise, in a "whack-a-mole" kind of exercise, where issues are taken on one at a time through impromptu changes in course or litigation strategies, typically only after the costs of the current approach become unmanageable.

But with an increasingly sophisticated plaintiff bar and litigation funders providing easily accessible and economically attractive funding, litigation has become more prevalent, more costly, and less likely to succeed, with more and more products being asserted as causing tort liability. This isn't just a trend – this is the new reality.

We've also seen large companies attempt to go on the offense – hiving off troubled operations through the "Texas Two-Step" that utilizes the Texas "divisive merger" statute to carve out certain isolated liabilities and a corresponding set of assets, then file the company holding the isolated liabilities for bankruptcy in an attempt to channel litigation claims into a single proceeding and put an end to litigation against the parent company. So far, that strategy has not resulted in a confirmed bankruptcy plan and, in fact, several of these two-step or similar efforts have resulted in dismissed bankruptcy cases and a reversion to the tort system. Thus, it would seem that taking drastic offensive actions – such as the Texas Two-Step – only after problems have become unwieldy is not a panacea for dealing with mass tort liabilities.

Similarly, waiting until things get so bad that a company must resort to a "free fall" bankruptcy doesn't seem like the right answer. Sure, claims are stayed by the protections of the automatic stay and can be channeled through a chapter 11 plan of reorganization, but this means filing bankruptcy for the entire company, which is costly, time-consuming, and can be brand-damaging, not to mention likely to decimate company stock. It is, therefore, understandable that companies would like to avoid subjecting their entire business to bankruptcy.

So what is left to do, other than to remain diligent on regulatory matters and litigate where necessary? The short answer is to get your corporate house in order. It's what some are calling "structural optimization" – reorganizing internally to try and predict future problems through reallocation of assets and liabilities, done in a way that anticipates and protects against later challenges by creditors.

Structural optimization - how it's done

Taken to the extreme, structural optimization aims to segregate within your corporate structure all potential liabilities from go-forward operating or other valuable assets, leaving the liabilities behind and transferring excess assets into entities that are distinctly separate. This way, if done properly and a claim is brought later by

a plaintiff, such claim should only exist against that isolated entity. We've seen this done – and done well – in the past with companies that have historic liabilities like asbestos. In those cases, after performing an analysis of the corporate structure, every single entity that had actual or potential exposure with asbestos was identified and its assets and liabilities analyzed. Then the "good assets" were moved out of that entity into a newly formed entity – one that had no asbestos exposure. This process is repeated until all entities with potential asbestos liability consist only of that liability and a corresponding amount of cash, notes, or other non-operational assets to support those liabilities and remain solvent entities. This simple concept can have powerful results, especially when done years in advance of any claims arising.

Why is solvency important? Solvency is a major factor in fraudulent transfer risk. All states (and the Bankruptcy Code itself) have fraudulent transfer/conveyance laws that say essentially the same thing: if you make a transfer of assets for less than fair/reasonably equivalent value at a time when the transferor is insolvent or rendered insolvent by the transfer, that transfer is subject to claw-back. Therefore, if the transfers suggested above are not made by insolvent companies – and the companies are not rendered insolvent by the transfer (meaning enough assets are left behind to cover the liabilities) – then the transfers are typically not subject to claw-back because the key element has not been satisfied.

Even if the solvency test isn't met, companies can still do an internal structural optimization substantially ahead of time such that the statute of limitations for bringing any fraudulent transfer claims runs. In other words, if the transfers took place at least four or six years in advance of the fraudulent transfer action (depending on the time imposed by state law), and no actual fraud claim can be sustained, then, even if the transfer would have been avoidable, the claim will likely be time barred, as it is outside the statute of limitations. To summarize, if a structural optimization exercise is performed, and it was not done in an attempt to defraud creditors and took place earlier than the relevant statute of limitations, then the transfer will most likely not be subject to claw-back. Structural optimization is therefore a powerful tool for a company to use to shield assets that might otherwise later be subject to a tort claim.

To further the case against a claw-back, obtaining expert opinions from investment bankers can be really helpful to show that the transactions were fair, representing fair value, and left the transferor solvent at all times. While not bulletproof, this evidence will be harder to refute as the time between the transaction and the potential claim passes.

Nothing in this approach necessitates a change to a company's ongoing litigation strategy, which can still be pursued aggressively. The goal of structural optimization is to limit the pool of assets available to successful claimants if the litigation approach were to fail or become too costly.

Disaffiliation

Structural optimization alone does not eliminate liability from the family of companies – it just isolates those liabilities from the "good" assets of the family, so that they are harder to reach to satisfy legacy liabilities. Moreover, from an accounting perspective, these liabilities must be accounted for (and for a public company, disclosed) in any consolidated set of financials. That can have a negative effect on the value of the company because the market might have an even dimmer view of the actual liabilities than the company.

One option is to transfer/sell the "oldco" entities outside of the family of companies so that it is now owned by an unaffiliated entity, in a move known as "disaffiliation." This kind of a transfer seeks to permanently divest the unwanted liabilities and related assets and take them off the company's books for good.

But who would want to buy this stuff? As you can imagine, there is a market for everything, and "oldco" liabilities and their offsetting assets are attracting a new kind of buyer, notably special situations asset and liability managers. What's

in it for them? The ability to manage money as it is used to satisfy long-term liabilities over a long period of time has meaningful value, both in terms of fees charged for the management but also potential for residual value if they are able to generate investment returns on the assets in excess of the ultimate tort liability (which they will, of course, seek to minimize through litigation). Further, these "oldcos" are typically "over-collateralized" such that there is more than enough in assets to satisfy the liabilities because of (1) buyers insisting on over-collateralization to ensure there is no funding gap at the end; (2) sellers, who want to ensure that the "oldcos" are solvent (and therefore not subject to fraudulent transfer risk) to minimize claimants returning later with unsatisfied claims; and (3) the buyers administering the tort liability for less than the upfront estimated exposure. Moreover, these buyers are often sophisticated investors with significant experience in the tort world and have the knowledge and support necessary to help convince the seller that disaffiliation is a viable and safe option.

Consider starting small

While relatively simple to describe, this whole effort can seem daunting. Do I need to restructure my entire business? What about tax consequences? How can I predict what my problems of tomorrow will be today? It can be hard to know where to start and how to approach it all.

The best approach is to start with a bite-sized project. Do you have a particular issue you can see materializing down the road that might not necessitate a full-scale corporate reorganization but would benefit from isolating liabilities? Start there and see what undertaking this kind of effort might involve, so you can better analyze the cost-benefit. It is possible, or even likely, that once you've started the process, performing a more comprehensive change can be better understood and considered.

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