

# Funds Talk



Kramer Levin's **Funds Talk** provides legal commentary on the news and events that matter most to alternative asset managers and funds.

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## Facing a Growing Number of Bankruptcies, the Coal Industry Becomes Potential Target for Alternative Investment Funds

### — Bankruptcy

Once a giant of the U.S. economy, the coal industry now faces uncertain times due to lower global demand, a boom in domestic natural gas production, over-levered capital structures and stringent environmental regulations. This depressed environment has attracted the attention of certain distressed investors and alternative investment funds looking to capitalize from an eventual upswing in the coal industry.

After peaking in 2008 at 1.17 billion short tons, U.S. coal production dropped to 995.8 million short tons — its lowest level since the late 1980s. Metallurgical coal dropped from \$330 per ton in the second quarter of 2011 to \$117 per ton in the first quarter of 2015. Several factors have contributed to the depressed pricing of metallurgical coal, including lower demand from Chinese and European steel producers and greater supply from Australian mines.

At the same time, demand for thermal coal has dropped as power companies have turned to natural gas, in part because “fracking” has made natural gas abundant and cheap, and in part because the EPA’s environmental regulations have compelled power companies to shut most coal-burning plants.

Those plants are not coming back even after the Supreme Court’s June 29, 2015, rejection of mercury emission regulations (known as “MATS”). The decision is at most a temporary setback for the EPA; it preserves the ability of the few remaining plants to burn coal for another year.

Finally, federal and state coal regulators (e.g., Wyoming)

are questioning whether coal producers are financially able to “self-bond” their reclamation obligations. A company that cannot self-bond must obtain a bond from a surety company, which will in turn demand cash collateral or a letter of credit, potentially creating a liquidity crisis.

Emblematic of the plight of a coal producer in the present coal market is Patriot Coal Corporation (“Patriot”), a leading producer of thermal and metallurgical coal. Patriot emerged from its first Chapter 11 in December 2013 only to file again in May 2015, citing low coal prices, enhanced regulation and pension liability issues. Patriot has \$791 million in secured debt and potentially over \$1 billion in unsecured claims; it is using chapter 11 to sell substantially all of its operating mines and has obtained a \$100 million debtor-in-possession loan from a group of Patriot’s largest prepetition secured lenders.

Other coal companies are under increasing financial stress. Shares in Walter Energy – over \$140 in 2011 – have dropped below \$1 and the company has more than \$3 billion in debts. Alpha Natural Resources, Arch Coal and Peabody Energy have also seen their stock value drop by 90%, 88% and 85%, respectively, over the past 12 months. The bonds for these companies are trading at distressed levels. Wyoming has put Alpha Natural Resources on notice that it may have to bond over \$400 million in reclamation obligations. As Patriot’s former owner, Peabody may face a claim by the 1974 UMWA Pension Plan in excess of \$700 million. Both Alpha and Peabody have hired restructuring advisers.

In sum, coal is a dramatically depressed industry that may present an opportunity for funds willing to bet on a rebound in foreign and domestic demand. Numerous coal producers are seeking to sell assets or consolidate operations as a way to build up their strength in the current market and are engaging in negotiations with their bondholders to find ways to restructure their liabilities.

Alternative funds are becoming increasingly active in distressed coal producers. Smart fund managers,

however, should be aware of the peculiarities inherent in coal restructurings. Coal industry union contracts, pension obligations, retiree medical obligations and environmental liabilities have their own dynamics and peculiarities. Senior management can face personal liability under state and federal mining permits. A company with profitable and losing subsidiaries may find it cannot shed bad mines without having permits “blocked” for its good mines. Offshore funds may encounter tax complications from receiving equity for their bonds in a restructuring.

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Investors seeking to profit from the challenges of coal restructurings should seek advice from experienced counsel. Kramer Levin represented Patriot’s unsecured creditors in its first chapter 11, and in the second chapter 11 currently represents the secured lenders who hold most of Patriot’s first and second lien notes and have funded Patriot’s DIP loan. Kramer Levin also represented the independent directors of International Coal Group in its merger with other entities owned by the investor Wilbur Ross. ■

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## Margin Requirements for Uncleared Derivatives — Implementation Update

### — Derivatives

With the [release](#) of a revised implementation timeline for margin requirements for uncleared derivatives (the “Basel framework”) in March, the Basel Committee on Banking Supervision (“BCBS”) and the International Organization of Securities Commissions (“IOSCO”) signaled that they have solidified the scope of uncleared swap margin regulations.

The Basel framework was devised following an extensive process of proposals and feedback. Despite that process, following the release of the framework in 2013, the organizations received a large volume of comments, thereby prompting the [delay](#). As a result, the requirement for financial firms (as defined by national regulators) to collect and post initial margin will be delayed until September 2016. The requirement for those firms to exchange variation margin will also be delayed until September 2016, and will be subject to a six-month phase-in period.

The Basel framework margin requirements, designed with the dual purpose of reducing systemic risk and promoting central clearing, apply to all uncleared derivatives, with the exception of physically settled foreign exchange forwards and foreign exchange swaps. Additionally, the margin requirements will not apply to uncleared derivatives involving nonfinancial entities (as defined by national regulators), as such transactions are considered to pose little to no systemic risk and are generally exempted from most countries’ central clearing mandates.

Based on the original Basel framework, the Commodity Futures Trading Commission and the various banking prudential regulators (collectively, the “Regulators”) proposed that

uncleared derivatives margin rules (the “Proposal”) primarily apply to swap dealers and indirectly to financial end users (such as investment funds) with material swaps exposure. Material swaps exposure is defined as an average daily aggregate notional amount of uncleared swaps, uncleared security-based swaps, foreign exchange forwards and foreign exchange swaps (“uncleared swaps products”) with all counterparties for the business days in June, July and August of the previous calendar year exceeding \$3 billion.

Pursuant to the Proposal, swap dealers are required to collect initial margin for uncleared swaps with counterparties that are financial end users with material swaps exposure. The amount of initial margin will be equal to or greater than an amount determined through either a risk-based model (approved by the Regulators) or a standardized table method (set forth in the Proposal). In either case, market participants may see changes to the way their swap dealers’ counterparties calculate initial margin.

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The Regulators proposed a phased-in compliance schedule for initial margin requirements, beginning Dec. 1, 2015, for swap dealers and counterparties that each have \$4 trillion in average daily aggregate notional amount of uncleared swaps products for the period mentioned above. All market participants would eventually be covered by Dec. 1, 2019.

The Proposal also requires that swap dealers

exchange variation margin with all financial end users (regardless of whether such end users have a material swap exposure), and allows swap dealers to net across trading agreements that meet certain minimum requirements. As a result, certain investment funds that are not currently receiving variation margin under their trading agreements may become entitled to receive such amounts. The rules with respect to variation margin are proposed to take effect Dec. 1, 2015.

Since BCBS and IOSCO have officially delayed the implementation of the Basel framework until September 2016, market participants will need to monitor how and when the Regulators will update and finalize their Proposal. The adoption of final rules will be noteworthy, as such rules have the potential to change the amount of initial margin and variation margin to be exchanged by investment funds and their dealer counterparties. In that respect, ISDA is currently developing a standard initial margin model intended for broad use by market participants under their credit support documentation. Legal documentation will also need to be amended to accommodate the new regulatory requirements. ■

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## **Dodd-Frank Reform Bill Would Loosen Regulatory Burdens on Some Insurers**

### **– Insurance**

Like the “Collins fix” signed into law by President Obama late last year, legislation now being considered by the Senate would signal potential relief for some insurers affected by Dodd-Frank and a more flexible approach on the part of the federal government to insurance matters.

The Financial Regulatory Improvement Act of 2015,

[reported out](#) by the Senate Banking Committee in June, has drawn attention mostly for its provisions on the Federal Reserve, community banks and credit unions. However, it also contains several elements that could specifically affect insurance companies, as the Federal Reserve’s Board of Governors assesses how to apply Dodd-Frank’s capital and other regulatory requirements to insurance companies coming under its jurisdiction – generally insurers designated systemically important financial institutions, or SIFIs, and insurers owning depository institutions.

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### *First among its insurance-specific provisions, the bill reaffirms Congress’ commitment to the McCarran-Ferguson Act.*

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First among its insurance-specific provisions, the bill reaffirms Congress’ commitment to the [McCarran-Ferguson Act](#), which codifies the primacy of the states in regulating the business of insurance.

Second, the legislation clarifies a key requirement relating to insurers that are savings and loan holding companies, affiliates of a depository institution or companies that control a depository institution. The bill limits circumstances under which such an insurer may be required to be a “source of strength” for the related financial institution, specifying that any such “source of strength” requirements will be subject to the constraints imposed by the Bank Holding Company Act. These constraints, generally, require the Federal Reserve’s Board of Governors to defer to state insurance regulators when seeking to require an insurer to provide support to the affiliated bank.

Third, it adds rehabilitation as an action that a state insurance regulator may take (in addition to liquidation) in order to preclude the Federal Deposit Insurance Corp. from exercising its backup authority to commence insolvency proceedings against an

insurer that is a “covered financial company” under the Orderly Liquidation Authority provisions of Dodd-Frank.

Fourth, the legislation would prohibit the FDIC, where it is acting as receiver for an insurance company that is a “covered financial company,” from taking a lien on the insurer’s assets unless the state insurance regulator is notified, the lien is to secure repayment of funds extended to the company, and the lien would “not unduly impede or delay the liquidation or rehabilitation of the insurance company, or the recovery by its policyholders.”

Fifth, the bill states that the Federal Reserve’s Board of Governors and the director of the Federal Insurance Office should “achieve consensus positions” with state insurance regulators when negotiating before any international forum of financial regulators or supervisors considering insurance regulatory issues.

Sixth, it would establish an Insurance Policy Advisory Committee on International Capital Standards and Other Insurance Issues at the Federal Reserve to advise on the application of these standards as well as other insurance-related matters.

Lastly, the legislation would institute annual reporting and mandatory testimony to Congress by the treasury secretary and the chairman of the Federal Reserve’s Board of Governors regarding developments at “international standard-setting regulatory or supervisory forums” as well as on the “impact on consumers and markets in the United States” prior to “the adoption of any key elements in any international insurance proposal or international insurance capital standard,” a

reference to “ComFrame” and related initiatives of the International Association of Insurance Supervisors. ■

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### Upcoming Event

**Banking and Finance Seminar:  
US-EU Investment Fund Update**

Sept. 17, 2015, Paris, France

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