

# The debtor's perspective: an overview of the options available to a company facing distress

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Various circumstances may force a company into an untenable financial condition. Regardless of the cause, any company facing financial distress must understand the basic options available to address its problems and then determine an appropriate strategy and tactics to implement that strategy.

A distressed company's various constituents have varying degrees of influence in this process. Those with the greatest influence are likely to be quite sophisticated in dealing with these issues. The company's management team must understand the steps involved in analysing, determining, negotiating and executing a solution.

This chapter broadly considers the basic options available to a distressed company. It then looks at the major events of a Chapter 11 case (for more information see *Chapter 11 "101" The Nuts and Bolts of Chapter 11 Practice*, American Bankruptcy Institute, Jonathan P Friedland, Michael L Bernstein, Prof George W Kuney, and Prof John D Ayer, 2007). It takes the point of view of the distressed company or debtor.

## Understanding the options

Solutions may include, individually or in combination:

- extending maturities;
- lowering interest rates;
- converting debt to equity;
- carrying out an operational restructuring; and
- selling substantially all of a debtor's assets and distributing the proceeds to creditors.

In the United States, strategies to deal with financial distress are typically accomplished through one of the following:

- a non-Chapter 11 alternative to Chapter 11;
- a free-fall Chapter 11 filing; or
- a pre-packaged or pre-arranged Chapter 11.

It is often prudent to pursue multiple strategies on alternative tracks – for example, negotiating an out-of-court work-out while also preparing to file for Chapter 11 in the event that the out-of-court path is unsuccessful.

## Alternatives to Chapter 11

Chapter 11 of the US Bankruptcy Code was largely enacted to foster rehabilitation. Accordingly, there are many provisions in the code and interpretive case law that protect, rather than punish, a debtor. The concept of the automatic stay is a well-known example of such protection. Chapter 11 is also fairly uniform throughout the 50 states (the code itself is uniform, while case law provides some variation). This brings a degree of certainty to formal Chapter 11 proceedings. Finally, Chapter 11 is inherently flexible.

Notwithstanding its substantial benefits, Chapter 11 is an expensive and disruptive process. Moreover, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has introduced more expense and uncertainty into Chapter 11 than was present before. For these reasons, stakeholders are increasingly looking to non-Chapter 11 alternatives.

Non-Chapter 11 alternatives can be divided into three categories:

- out-of-court restructurings;
- assignments for the benefit of creditors (ABCs) and receiverships; and
- Chapter 7.

### **Out-of-court restructurings**

Out-of-court restructurings can vary significantly in terms of the structure and magnitude of the transaction.

An out-of-court restructuring may mean that a company will alter its debt composition by swapping debt for equity or converting a credit facility debt into long-term bonds. Alternatively, it may mean a composition agreement whereby creditors agree to accept a certain distribution in full satisfaction of their outstanding claims.

Viewed most simply, a composition agreement is simply a contract between the debtor and one or more of its creditors. A debtor will sometimes send composition agreements to each of its creditors that require, as a precondition to the company's obligation thereunder, that a certain set percentage of the debtor's creditors and claims accept the composition in order for such agreement to be binding. Another situation might involve the company instituting an exchange offer to exchange existing publicly held debt for new debt securities with a lower interest rate or an extended term, or for new equity in the reorganised company.

Generally, out-of-court restructurings have a smaller impact on operations and fewer transaction costs. In an out-of-court scenario the company and its constituencies will almost certainly have more privacy than in a Chapter 11 filing. Once a company files a Chapter 11 petition, certain corporate actions will need the approval of the bankruptcy court and filed documents become a matter of public record.

Out-of-court restructurings can be an impractical mechanism for some debtors – for example, if there are many creditors whose debts must be compromised but who cannot be gathered for negotiations, or if some creditors simply refuse to agree to a deal that the majority is willing to accept.

There are also certain remedies available to a company in bankruptcy that can address operational issues that are simply not otherwise available.

### **ABCs and receiverships**

A popular liquidation alternative is an ABC. Many states provide for this alternative to bankruptcy. An ABC is a voluntary insolvency process in which the debtor assigns all its property to a designated assignee for liquidation. The assignee then liquidates the property and distributes the assets to the company's creditors in accordance with certain procedures and priorities.

The process varies from state to state. Less favourable schemes treat the process much like a probate estate. Other states offer a more streamlined process. Similar to a trustee in bankruptcy, an assignee may have standing to prosecute and defend claims on behalf of and against the debtor or assignor. However, other states have no ABC process to speak of; instead practitioners use liquidating composition agreements or simple wind-downs, sometimes followed by dissolutions.

Another liquidation option is a receivership. In a receivership a company's assets are placed under the control of a receiver (a court-designated party) so that value can be preserved for the benefit of creditors. Receiverships function in many ways like assignments and in some jurisdictions the difference is largely one of nomenclature. Receiverships are more common where there is a true distinction, for example with respect to real estate.

### **Chapter 7**

Chapter 7 of the Bankruptcy Code provides another more formal and regimented procedure for the orderly liquidation of a company's assets, followed by the payment of creditors' claims in the order of priority set forth in the Bankruptcy Code. Upon the filing of a Chapter 7 petition, a trustee is appointed by the Office of the United States Trustee and charged with marshalling all of the company's assets, liquidating them and eventually distributing the proceeds to the company's creditors.

Unlike an assignment for the benefit of creditors, the debtor does not have the ability to choose the trustee in a Chapter 7. Moreover, Chapter 7 proceedings are governed by a detailed and often cumbersome series of complex rules. Together, these factors result in a loss of control over the liquidation process.

## Chapter 11

A key benefit of Chapter 11 over Chapter 7 and the other liquidation alternatives discussed here is that Chapter 11 typically permits the company to remain in control of the process as a debtor in possession. However, throughout the Chapter 11 process the debtor in possession's decisions remain subject to bankruptcy court approval and review by the Office of the United States Trustee and committee (if any). If reorganisation, rather than liquidation, is the goal, Chapter 11 may be the only viable option available to the company.

Chapter 11 has a number of significant advantages over an out-of-court restructuring in the context of a restructuring. The automatic stay is but one example. Other advantages include the power to:

- reject undesirable contracts;
- sell non-core assets free and clear; and
- bind minority dissenters to a restructuring plan to that plan.

In addition, an involuntary bankruptcy will generally remain a risk during the pendency of an out-of-court restructuring. However, Chapter 11 is not without its costs. First, hard costs are substantial. Moreover, there are a number of substantive and procedural obligations to which a company becomes subject the moment it files for bankruptcy. Furthermore, the reaction of the debtor's various constituencies (ie, suppliers, customers, employees) must be carefully considered before a Chapter 11 filing.

In any event, filing for Chapter 11 is commonly a decision that is made not in isolation, but with keen regard to other options. Indeed, the very strengths of Chapter 11 can work together to reduce the need for a distressed company to resort to Chapter 11, since the relevant parties are able to negotiate against the backdrop of the 'what if' scenario of a Chapter 11.

Figure 1 sets out one way to conceptualise the various options.

### Free-fall Chapter 11 filings

In some instances distressed companies file for Chapter 11 only after exhausting all other alternatives and after months of planning. Thus, a Chapter 11 filing can be a well-orchestrated event preceded by thorough preparation and planning. However, in other cases a company may be forced into filing for Chapter 11 relief with very little

warning or planning. In any case, if the company enters Chapter 11 without a clear end goal at the outset, it is generally referred to as a free-fall Chapter 11. The end goal may be a liquidation (ie, a sale of the company followed by the distribution of the proceeds of the sale pursuant to a Chapter 11 plan) or a true reorganisation, in which the historical debtor entity continues.

### Pre-packaged and pre-arranged Chapter 11 cases

In contrast to a free-fall Chapter 11 case, a pre-packaged Chapter 11 is filed to achieve a clear strategy that has been agreed by all necessary parties before the Chapter 11 case is filed. This is accomplished by frontloading all negotiation, documentation and solicitation of a bankruptcy plan that serves to memorialise the chosen strategy. Thus, a pre-packaged Chapter 11 plan is negotiated and accepted by the requisite number and classes of creditor and/or shareholder before a proceeding is commenced in the bankruptcy court. As negotiation, drafting and solicitation are already complete by the time the debtor commences its bankruptcy case, the period of time that the debtor spends in Chapter 11 can be very short, and therefore less costly and damaging for the debtor than a free-fall Chapter 11.

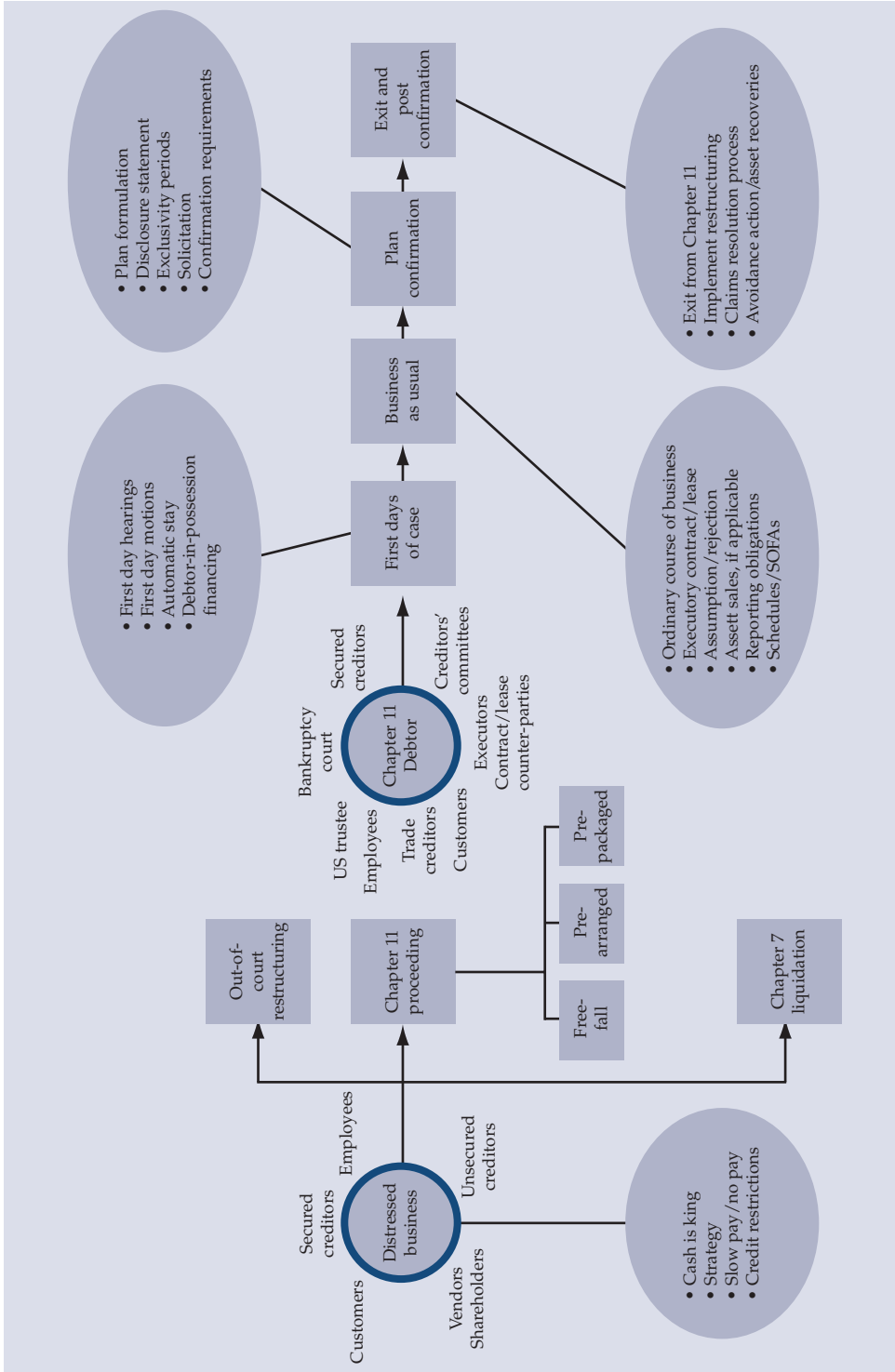
A pre-arranged bankruptcy is a more fluid concept. In its most general sense, a pre-arranged bankruptcy typically refers to a restructuring that is:

- negotiated with representatives of the most significant constituencies that are expected to be impaired (usually the senior lenders, bondholders or principal equity holders);
- agreed to by some or all of those representatives; and
- memorialised in a written agreement setting forth all or most of the definitive terms of a plan of reorganisation.

The most significant differences between the two approaches are that in the pre-arranged plan context, the major constituencies usually enter into a lock-up agreement whereby they commit to support the plan process, but the official solicitation of votes is not commenced until after the commencement of the Chapter 11 case itself.

Pre-packaging or pre-arranging a Chapter 11 reorganisation enables a debtor to minimise the negative impact on its ongoing business operations by combining many of the best aspects of out-of-court workouts (eg, cost, efficiency, speed,

Figure 1



flexibility and cooperation) with the binding effect and structure of a conventional bankruptcy.

### **Preparing and planning for a restructuring**

Even the simplest out-of-court restructuring can hit a snag and unravel, leaving the distressed company worse off than before. In addition, it is often important to be able to represent to stakeholders credibly that a Chapter 11 filing will be made if a consensual out-of-court deal cannot be reached. Consequently, even if a distressed company believes that the chances of a Chapter 11 filing are minimal, it may nonetheless be prudent to plan for a potential Chapter 11 filing. Fortunately, many of the early-stage planning concepts and considerations are the same for an out-of-court restructuring as for a Chapter 11 filing. Although each company's situation is unique and each industry presents its own challenges, some concepts are fundamental to any restructuring plan and should be addressed and examined as early as possible.

### **Retaining advisers**

Perhaps the single most critical decision a debtor will make is the selection of its financial and legal advisers. Experienced and well-regarded restructuring and insolvency specialists are essential to guide a company's management through what is at best a difficult and stressful process.

### **Cash-flow projections**

The distressed company should analyse its projected cash flow to ascertain both its short and long-term positions in order to determine whether there is sufficient cash flow for current needs. There are sophisticated lenders which specialise in lending to distressed companies. The ability to lien up assets can be a means to smooth cash flows. Conversely, having no unencumbered assets limits a distressed company's options.

### **Capital structure**

A distressed company's capital structure should be analysed to assess the interests of all stakeholders and to determine its assets and liabilities. This is essential for many reasons – for example, creditors can exert varying levels of leverage on a debtor depending on where they sit in the capital structure. In the event of a restructuring that calls

for dilution of stock, the agendas of a debtor's equity holders may diverge from that of the debtor. It is important to understand this early so that the board of directors can manage its fiduciary duties accordingly. This process also helps a company to determine the location of its assets and liabilities, which in turn drives venue options.

### **Valuation**

Two types of valuation are critical to a company's restructuring planning and negotiations: going-concern valuation and liquidation valuation. A common dynamic is that creditors are more likely to agree to a proposed restructuring plan that permits the company to continue to operate only if they will receive more under the proposed restructuring plan than they would if the company liquidated. This parallels the requirement for plan confirmation in Chapter 11. Therefore, it is common for parties to engage financial advisers to conduct liquidation analyses of the company to determine whether the proposed restructuring is in their own particular best interests.

### **Labour issues**

If labour cost reductions are contemplated as part of a restructuring, a distressed company must understand how much flexibility it realistically has to restructure its workforce outside bankruptcy. Some industries are heavily dominated by labour unions. If a distressed company expects that reductions in its labour force are a necessary component of its restructuring plan, labour unions can be formidable opponents – or allies. If heavy opposition from labour unions is anticipated, a distressed company may find that the structure, control, transparency and oversight afforded to a debtor in bankruptcy could be advantageous.

In the United States, workforce reductions or certain modifications or terminations of employee benefits plans can implicate a host of complex non-bankruptcy laws. These include federal employment and tax and state wage laws, which can impose liability on a debtor's affiliate corporations and, in some cases, impose personal liability on a debtor's directors and officers. For example, the plan sponsor of a defined pension plan covered by Title IV of the Employee Retirement Income Security Act of 1974 (as amended), and each member of its 'controlled group', are jointly and severally liable for the plan sponsor's termination liability including, without limitation, unpaid

minimum funding contributions and unpaid premiums. Consequently, in the event that a debtor terminates a defined pension plan, the debtor's affiliated corporations (including non-debtor foreign affiliate corporations) may be jointly and severally liable for the debtor's termination liability.

### **Relative interests of parties**

The relative leverage of equity holders, security interest holders and new lenders, to name just a few parties that may be involved, should be assessed early in the planning process to help the company navigate the negotiations. For example, preferred equity holders with a super-majority voting requirement need to be identified and involved as appropriate in the restructuring transaction. Existing lienholders also possess leverage in negotiations, particularly with respect to new financing arrangements.

In contrast to a Chapter 11 process, outside bankruptcy there are no mechanisms to bind the dissenting creditors to a company's restructuring plan. If the distressed company believes that there may be dissenting shareholders who are unlikely to agree to a proposed out-of-court resolution, a Chapter 11 proceeding may be unavoidable to carry out the restructuring. Moreover, the risk of an involuntary bankruptcy proceeding must constantly be addressed.

### **Executing the commercial loan work-out**

#### **Conducting initial negotiations**

Once a distressed company realises that a financial restructuring is in order, it typically retains restructuring counsel and initiates formal meetings with key constituencies to inform or update them of its impending or ongoing financial difficulties and raise the prospect of a financial restructuring. The debtor should be prepared to:

- explain why a financial restructuring is necessary;
- establish who the principal negotiators will be; and
- propose the debtor's preferred solution in general terms.

Typically, a debtor's external financial adviser also participates.

Following these initial meetings, the various creditors may form one or more *ad hoc* committees. These *ad hoc* committees will serve as the

negotiating representatives for their respective creditor constituencies in reaching an agreement with the debtor. The debtor will need to share information with its constituents and their professionals so that the parties can conduct their own due diligence.

### **Documenting the restructuring**

Once a restructuring transaction has been tentatively agreed, the parties can focus on documenting the proposed transaction. The process will depend in large measure on the nature of the debt being restructured. For instance, if a debtor is restructuring a private bank loan with new lenders, the restructuring transaction would likely be documented in a credit agreement or other loan document between the debtor corporation and its new lenders. However, if the debtor has to restructure publicly held securities through an exchange offer of new securities, the new securities issuance must be registered with the Securities and Exchange Commission or qualify as exempt from the registration requirements of the Securities Act of 1933. Many exchange offers are pursued in tandem with a pre-packaged Chapter 11, which requires the debtor to solicit tenders for its exchange offer and votes in favour of its pre-packaged plan concurrently. The pre-packaged plan of reorganisation, which would be filed only if the debtor failed to secure enough votes for its exchange offer, contains basically the same terms as the exchange offer.

### **Reorganising under Chapter 11**

#### **Commencing a Chapter 11 case**

A debtor begins a Chapter 11 case by filing a bankruptcy petition with a bankruptcy court. The distressed company then becomes a debtor in possession. A debtor will remain a debtor in possession until:

- the debtor's plan of reorganisation is confirmed;
- the case is dismissed or converted to a Chapter 7; or
- a Chapter 11 trustee is appointed.

Although the terms 'debtor' and 'debtor in possession' do not have identical meaning under the Bankruptcy Code, they are generally used synonymously.

Once a case is filed, the debtor gains the immediate protection of the automatic stay, which

provides an invaluable respite for the debtor while also protecting the creditors as a group by prohibiting individual creditors from enforcing their claims under state law, thereby keeping the debtor's estate intact. However, other provisions of the US Bankruptcy Code which become immediately effective upon a debtor's Chapter 11 filing can impede a debtor's ability to operate its business. For this reason, a great deal of time is spent by a debtor and its counsel preparing first-day motions which seek orders from the bankruptcy court reversing or limiting the effect of these provisions (for more information on first-day motions, see "First Things First: A Primer on How to Obtain Appropriate 'First Day' Relief in Chapter 11 Cases", *Journal of Bankruptcy Law and Practice*, Vol 11 No 4 2002, Fall 2002, James HM Sprayregen, Jonathan P Friedland and Ryan Nadick).

### **Operating a business as a debtor in Chapter 11**

A debtor may use, sell or lease its property in the ordinary course of its business without authorisation from the bankruptcy court. This authority generally enables a debtor to operate its business without having to go to court to get authority to conduct ordinary transactions.

### **Financing in Chapter 11**

Some debtors have enough unencumbered cash to enable them to operate in Chapter 11 without new cash infusions. Others must rely on cash that is subject to a lender's security interest, referred to in Chapter 11 as "cash collateral". A debtor must obtain court authorisation or the agreement of secured parties to use cash collateral. If a creditor does not consent to the use of its cash collateral, the court must find that the debtor is able to provide adequate protection to the lender.

The Bankruptcy Code also permits a debtor to borrow funds and offers protections and priorities to induce lenders to make these loans, which are referred to as debtor-in-possession loans.

### **Modifying contractual obligations in Chapter 11: assuming and rejecting executory contracts and leases**

Section 365 of the Bankruptcy Code generally authorises a debtor to modify its pre-bankruptcy executory contracts. As a general matter, a contract is 'executory' if performance remains due to some extent by both parties. A debtor can assume and

continue to perform under such contract, assign the contract to a third party or reject the contract.

By assuming or assigning an executory contract, the debtor binds itself or its assignee and all other contracting parties to perform the contract. By rejecting an executory contract, all parties are generally relieved of most further obligations under the contract. The decision to assume, assume and assign or reject a contract requires court approval, but courts typically defer to the debtor's business judgement.

Until a contract is assumed or rejected, both the debtor and the non-debtor party are generally obligated to perform under it. As a general rule, but with an important exception for most commercial real estate leases, a debtor is not obligated to make the decision to assume, assign or reject until the confirmation of a plan.

### **Satisfying creditors' claims**

A debtor is obligated to file schedules of all its debts as of the petition date. Subsequent to this, creditors file proofs of claim documenting their alleged claim against the debtor. The deadline by which all proofs of claim must be filed will be set by the bankruptcy court. Once the deadline has passed, the debtor will combine its scheduled claims and the filed proofs of claim to generate a final list of all possible claims. The debtor and other parties can object to claims for any number of reasons.

Aside from allowing claims for payment purposes, claims play an important role in the plan voting and confirmation process. The plan proponent will designate classes of claim by essentially grouping claims that are "substantially similar" to other claims in the same class. Creditors vote on the plan with their class. To confirm a plan, a debtor (or other plan proponent) needs the approval of a majority in number and two-thirds in amount of claims in each voting class.

### **Plan formulation**

Most often the Chapter 11 plan is proposed by the debtor. During an exclusive period, the debtor has the sole right to propose a plan. Other parties may propose a plan after the exclusive period expires. The plan can provide that a creditor's claim will be paid less than in full or repaid over a longer period and/or at a different interest rate from that stated in the original instrument. A plan can also cancel existing issues of stock, replace existing issues with new issues or swap equity for debt and vice versa.

Moreover, articles of incorporation of the debtor corporation can be changed in a plan to alter the voting rights of different issues of shares or modify anti-takeover measures.

### **The disclosure statement**

Acceptance of a plan may not be solicited until the bankruptcy court approves a disclosure statement sufficient so a voter can "make an informed judgment about the plan". Thus, the disclosure statement serves the same function as a prospectus does for a new securities issue.

### **Solicitation**

After the approval of the disclosure statement, the proponent solicits votes. Voting is done on a class-by-class basis. In order for a class to be deemed to have accepted a plan, the plan must be accepted by a majority in number of voting creditors and at least two-thirds of the debt amount of voting creditor claims in that class. For these purposes, the claims of insider creditors do not count. The Bankruptcy Code provides that any creditor who is "impaired" by a plan can vote on the plan. If every impaired class of creditors votes to accept the plan, the proponent asks the court to confirm the plan. If no impaired class votes to accept the plan, the debtor cannot proceed with its plan as drafted and must return to the negotiating table. If some impaired classes vote to accept and others vote to reject, then the proponent may seek to cram down the dissenting classes if:

- at least one impaired class has voted to accept the plan; and
- the court finds that the treatment provided for objecting classes under the plan does not "discriminate unfairly" and is "fair and equitable".

### **Basic tests for confirmation**

Upon receipt of the necessary acceptances, the plan proponent will request the bankruptcy court to confirm the plan at the confirmation hearing.

The Bankruptcy Code requires that the bankruptcy court make a number of specific findings to confirm a plan and make it binding on all parties. These include determinations that the plan complies with all applicable law and has been proposed in good faith. The bankruptcy court must also determine that the plan is feasible.

If any individual creditor votes against the

plan, the plan must also pass the 'best interests of creditors' test, which requires that the bankruptcy court determine that the dissenting creditors or shareholders are receiving under the plan at least as much (in present value terms) as they would receive if the debtor were liquidated under Chapter 7. It requires the bankruptcy court to compare:

- the probable distribution to the dissenting creditors or equity holders if the debtor were liquidated; and
- the present value of the payments or property to be received or retained by the same creditors or equity holders under the plan.

Stated more simply, if a class votes in favour of the plan, the plan will be binding on dissenters in that class as long as dissenting class members are getting at least as much as they would in a liquidation.

### **Recovering and avoiding pre-petition payments**

The Bankruptcy Code gives the debtor in possession certain powers to prevent unfair pre-petition payments to one creditor at the expense of all other creditors by allowing the debtor in possession to avoid certain pre-petition transfers of money or property. One such power is the power to avoid fraudulent transfers. A pre-petition transfer may be avoidable as either intentional fraud or constructive fraud. The former is a transfer made with the intent to hinder, delay or defraud creditors, possibly by hiding assets from creditors. The latter is a transfer made for less than reasonably equivalent value while the debtor is insolvent or which renders the debtor insolvent or leaves it with unreasonably small capital.

A debtor also possesses the rights of a lien creditor. This means that if a security interest is unperfected at the time of the bankruptcy filing, the debtor can set aside the security interest. Another example of avoidance powers is a debtor in possession's power to challenge and recover payments made by the debtor in the 90 days prior to the petition date if such payment was made on account of an antecedent debt. These types of payment are seen as payments that prefer some unsecured creditors over others. Debtors can reach back for preferences made up to one year before the petition date if the recipient is an insider of the debtor.

### **Post-confirmation**

Confirmation represents a significant achievement in

a Chapter 11 case and is generally viewed as the end goal of a filing. It represents consummation of the business deal between the relevant parties. However, in practical terms the case does not end with confirmation of a plan. In fact, a number of important aspects often remain to be completed after confirmation. These may include consummating transactions provided for in the plan, resolving disputed claims and litigating adversary proceedings.

## **Conclusion**

The resolution of financial distress must be a fluid process. Just when a situation appears to be on course, important changes can occur: creditor or creditor-debtor coalitions can form or disintegrate; perspectives and objectives can shift from long/medium to short/immediate term, or vice versa (as when debt trades); operating performance within various company divisions can decline.

Whatever the resolution, a wide-angle field of vision for issues, coupled with a range of realistic expectations, is more likely to foster the most constructive environment and generate the most progress. The best financial analysis or most cleverly drafted legal document is without value if it does not advance the ultimate business objectives. At the same time, the right business

objectives need to be determined based on an understanding of key factors such as the relative legal leverage of the parties and the realities reflected in the financials.

Silence, understated communication or hazy, migrating requests can create confusion and permit a fluid situation to drift, usually for the worse. To the maximum extent possible, problems and objectives should be explained, framed and made clear. It is important for advisers to let other advisers and principals, and sometimes the court, know that they are there, providing active, professional guidance, acumen and solutions for a management team likely to be encountering complex restructuring issues for the first time. (This conclusion borrows from "Five Rules For The (Restructuring) Road", *Daily Bankruptcy Review*, April 28 2004 at 8, James HM Sprayregen, Jonathan P Friedland and David A Bonington.)

*This chapter updates and expands "Commercial loan workouts from the debtor's perspective", which appeared in the Americas Restructuring and Insolvency Guide 2004/2005, co-authored with James HM Sprayregen, and Kathleen A Cimo.*

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