Leading companies in financial distress: key issues for chief executives

DJ (Jan) Baker, partner
John (Jack) Wm Butler, Jr, co-leader, global corporate restructuring practice
Sally McDonald Henry, partner
Skadden Arps Slate Meagher & Flom LLP

Major General Oliver P Smith, a Marine commander in the Korean War, once reportedly exclaimed when he was forced to pull back his troops, "Retreat [expletive deleted] – we're just attacking in a different direction!" Smith's message continues to have great resonance for business leaders today – sometimes, when the situation is dire, one must make use of what, under other circumstances, might seem to be an unappealing alternative. In today's economic environment, with liquidity dramatically reduced, capital markets volatile and a recession looming, many corporations may need to consider the possibility of Chapter 11. Over the past 25 years a wide variety of household names in corporate America have availed themselves of Chapter 11, generally with successful results. Looking at companies such as Armstrong, Delta Airlines, Federated Department Stores, Kmart, Mirant, Northwest Airlines, Owens-Corning, Pacific Gas & Electric, AH Robins, Texaco, US Airways and Winn-Dixie, it is clear that Chapter 11 has become if not routine, then so often used as to have become relatively unremarkable.

Indeed, while most companies and their stakeholders may generally prefer to restructure businesses outside of a formal judicial process, Chapter 11 reorganisation provides a unique forum for a company experiencing financial distress to obtain a fresh start with all the constituencies and stakeholders that may be involved. As both the bankruptcy laws and the courts set and enforce deadlines, the process of Chapter 11 has become increasingly expeditious, with all parties focused on achieving a rapid resolution of the problems that precipitated resort to a court-supervised process in the first place. As a result of revisions to Chapter 11 enacted in 2005, the process is typically both faster and less expensive than in the past.

Financial versus operational transformation

Chapter 11 is best known as a tool for companies with critical cash-flow problems or balance sheets that are dramatically over-leveraged. Once a case has been filed, the repayment of debts incurred prior to the filing is prohibited, except through a court-approved plan of reorganisation. Litigation by other companies or individuals against the debtor, as a company that has filed a case under Chapter 11 is known, is stayed. Interest on all unsecured debt stops accruing and the debtor receives a complete break from claims of unsecured creditors (and significant breathing room with respect to secured claims as well). As a result, suppliers that were previously reluctant to ship merchandise will often resume shipping after a company has filed Chapter 11, since companies providing goods or services after a Chapter 11 case has been filed must be paid before any payments may be made to pre-existing creditors. With the protections and priority found in Chapter 11, lenders will often make debtor-in-possession loans that might otherwise have been unavailable to the borrower. The attraction of Chapter 11 for lenders lies in the fact that, in return for making a debtor-in-possession loan, they are given collateral and granted payment priority over almost all other creditors.

Chapter 11's usefulness to a company experiencing financial distress lies primarily in the fact that all creditors – even non-consenting creditors – can be bound by the terms of a plan of reorganisation once it has been approved by the court. Outside Chapter 11, only those individual creditors that agree to restructure their debts will be bound by a restructuring. This limitation is one of the downsides of exchange offers, which can be of limited use in light of their inability to bind non-consenting debt holders. By contrast, in Chapter 11, once over half in number and two-thirds in amount of any group of creditors vote to accept a plan of reorganisation, all creditors in that group will be bound to the terms of the plan when the bankruptcy court has confirmed it. Indeed, in some instances (called 'cram-downs'), an affirmative vote is not necessary to bind creditors if a number of specific criteria are otherwise met.

Chapter 11 has also been employed with great success by companies facing massive product liability claims. Indeed, with respect to claims based on exposure to asbestos, the Bankruptcy Code specifically provides for a mechanism to pay not only claims that have already been brought against a company, but also claims that have not yet even been asserted. Other types of mass tort claim, including claims arising from pharmaceutical products, have also been successfully dealt with in Chapter 11. In many of these cases, not only mass tort claims against the company, but also claims against the company's officers and directors, have been resolved.

Chapter 11 can also be used to deal with legacy costs that impair a company's competitiveness. Airlines such as Continental, Delta, Hawaiian, Northwest and US Airways have all used Chapter 11 to renegotiate labour contracts that crippled their ability to compete with discount carriers. As a result of special provisions in the Bankruptcy Code, union contracts can be rejected by a debtor only if it has provided extensive financial information to its unions, negotiated with them in good faith and proved to the court that changes to existing union contracts are necessary in order for it to be able to reorganise. Likewise, burdensome healthcare or pension costs can be modified in Chapter 11 using a similar process.

Chapter 11 can also be a useful tool when companies need to exit geographic areas in which they have numerous leased properties. This is because a special provision of Chapter 11 limits the damages that a landlord can assert when a debtor terminates a lease, notwithstanding that the lease may have a remaining term of many years. Obviously the ability to limit the claims of landlords that could otherwise assert significant lease rejection damage claims is a great benefit if a company is a tenant in numerous long-term leases that it needs to terminate as part of a strategy to return to profitability. In addition, Chapter 11 will permit a debtor to assign leases and other contracts to third parties, notwithstanding provisions in the lease or contract that prohibit such assignments. Once a contract or lease has been assigned, the Chapter 11 debtor is released from all future obligations under the contract or lease, while the other party to the contract or lease is entitled to assert an unsecured claim for damages in the Chapter 11 case.

Finally, Chapter 11 can be a useful forum in which to sell assets that might otherwise be difficult to market because of concerns of potential purchasers with respect to both known and unknown liabilities. Although buyers of assets are generally not responsible for the seller's liabilities, there are circumstances in which courts have reached a contrary conclusion, such as finding that there was a *de facto* merger or determining that a buyer effectively continued the manufacture of a pre-existing product line. In other cases, because of the need to structure an acquisition as a share sale (perhaps to maintain licences), an asset purchase may not be viable for a seller. However, under Chapter 11 the court can order that a sale, whether of assets or stock, be made free and clear of the seller's existing liabilities.

An overview of Chapter 11

Although in theory creditors can force an insolvent company into Chapter 11, this happens extremely rarely. More typically, a Chapter 11 case begins with a company itself filing a petition for Chapter 11 relief. When a company decides to commence a Chapter 11 case, it does not have to show that it is insolvent: it is obliged only to file in good faith in order to use the restructuring laws for a legitimate purpose. It is often thought among turnaround professionals that the most common mistake that boards and management make before they decide to file a Chapter 11 case is delaying too long to recognise that a Chapter 11 filing is probable, thereby causing the filing to be made hurriedly and without time for adequate preparation. If a company delays in contingency planning, it could, for example, have its pipeline of merchandise or raw materials from suppliers disrupted, find its

shelves empty and lose important leverage in negotiating post-filing financing.

Delaying a filing that, with hindsight, was probably inevitable only reduces the chances of a successful reorganisation. Moreover, directors must be sensitive to their duties to all stakeholders when a company is in what the courts have come to call the 'zone of insolvency'. Under this doctrine, adopted in Delaware and other states, a company's board owes a fiduciary duty to creditors, as well as to shareholders, whenever the company is in the zone of insolvency. While under Delaware law this fiduciary duty does not create a cause of action for creditors against board members, a proactive approach can protect directors from claims that they acted too conservatively when a company is facing severe financial challenges.

When a company files a Chapter 11 petition, it typically remains in charge of its operations. Day-to-day decisions are still made by management and key decisions are made by the board of directors. However, an important point in Chapter 11 is that actions outside the ordinary course of business must be approved by the bankruptcy court, on notice to all parties, including a committee of creditors appointed as part of the reorganisation process. Indeed, sophisticated Chapter 11 debtors realise that the court will usually give careful consideration to the opinions of the creditors' committee. For that reason, debtors typically give a committee advance notice of any proposed requests for court approval and engage in a dialogue with the committee to address any concerns or questions that it may have. It is not unusual for discussions with a committee to lead a debtor to revise its initial proposal in order to obtain support from the creditors' committee. Of course, the company and the committee may not always agree; in such cases the bankruptcy court will determine whether to approve the debtor's request, usually applying a business judgement standard.

Changes in the Bankruptcy Code that became effective in 2005 affect a variety of issues in a Chapter 11 case. One key change involved the Office of the United States Trustee, which is the part of the Department of Justice that is charged with overseeing Chapter 11 cases for the executive branch. For years the bankruptcy laws provided for the appointment of a trustee for 'cause', including fraud, gross mismanagement or incompetence; if the bankruptcy court ordered a trustee appointed, the trustee would effectively displace the debtor's board and possibly its management. However, now the code requires that the Office of the United States Trustee ask the bankruptcy court to appoint a trustee if there are reasonable grounds to suspect that current members of management or members of the board of directors are engaged in fraud. This change in the law has led to many more attempts by the Office of the United States Trustee to have a trustee appointed, although the courts are still reluctant to impose the expense – and possible operating inexperience – of a trustee, especially if the company has taken appropriate steps to remove from authority parties who may have acted inappropriately. However, it remains unlikely that such a motion will be brought without allegations of fraud.

Once in Chapter 11, the normal process of corporate governance continues unabated, although it is ultimately subject to bankruptcy court supervision. A board of directors continues to have authority to direct the business and operations of a debtor, and members of management continue to discharge their regular operational responsibilities. Similarly, annual shareholders' meetings may continue, even though one of the consequences of Chapter 11 may be the dilution or even elimination of pre-existing shareholder interests under a plan of reorganisation. In practice, many debtor corporations suspend annual meetings during Chapter 11 cases, albeit at the risk of shareholders seeking relief in the Delaware Chancery Court or other appropriate forum to require that an annual shareholders' meeting be called by the company. Sometimes the bankruptcy will limit the rights of shareholders to require annual meetings if the bankruptcy court concludes that the meeting would interfere with the Chapter 11 reorganisation process – although it usually requires fulfilment of the irreparable harm standard.

The goal of Chapter 11 is to confirm a reorganisation plan that will allow a company to go forward with its business – either with the same or new shareholders – and preserve a company's going-concern value. The reorganisation plan is voted on by affected creditors. If any class of creditors votes to reject the plan, that class must be paid in full, over time, before any junior class is paid. Thus, for example, secured creditors must be paid before unsecured creditors, and unsecured creditors must be paid before shareholders. In addition, any individual creditor that does not vote for the plan must receive at least as much value as it would obtain if the company were liquidated. Sometimes stockholders receive little or nothing, as when debt is exchanged for equity. In some cases,

however, such as Hawaiian Airlines, Nextwave Communications and AH Robins, equity interests that existed before the Chapter 11 case was filed were preserved because there was sufficient value to pay the claims of creditors.

Chapter 11 negotiations

The statutory framework of Chapter 11 was designed to encourage a debtor and its creditors to engage in a process of negotiation to resolve outstanding issues and reach agreement on the terms of a plan of reorganisation. In addition, in special situations, *ad-hoc* committees of particular creditor groups (eg, tort claimants or creditors with rights to reclaim goods) may be formed. In some cases, especially those in which there is a likely recovery for existing shareholders, equity committees also may be formed. Indeed, such committees are sometimes given official status, which entitles them to have their expenses paid by the debtor to the extent that the court approves such expenses.

Outside Chapter 11, companies are understandably reluctant to share confidential business information with third parties, including creditors, but information sharing has become the norm with respect to a creditors' committee. An understanding of the information-sharing process and its built-in protection should help to allay concerns of the debtor's management. For example, committee members have a fiduciary duty to act in the best interests of all creditors. Violating that duty can have serious consequences. In the recent *FiberMark Case*, for example, the creditors' committee was disbanded following allegations that certain committee members had violated their fiduciary duty to work for the good of all creditors.

Similarly, because it is important for committee members to work in support of a company's rehabilitation, it is unusual for the Office of the United States Trustee to appoint committee members that are competitors of the debtor or may otherwise have an inappropriate agenda. Moreover, severe penalties can be imposed on participants in a Chapter 11 case that do not abide by their duty to use information they obtain through the Chapter 11 process solely for legitimate purposes. Recently, for example, the court found Mesa Airways liable for $80 million for misappropriating information that it learned about a debtor, Hawaiian Airlines, when it was considering purchasing that company during its Chapter 11 case.

For a number of years, debtors have been able to provide confidential information to their committees in order to reach agreement on the terms of a plan of reorganisation, yet remain confident that the committee would maintain the confidentiality of such information. However, in a last-minute change to the bankruptcy laws in 2005, a new provision was added to the Bankruptcy Code requiring a creditors' committee to "provide access to information" to its constituency – in other words, to creditors. Although commentators initially feared that this revision would be interpreted so broadly that it would impede the ability of a debtor to share information with an official committee, courts have interpreted the law in a reasonable way that has not limited the flow of information required to carry on negotiations with a committee. Indeed, it has become common for committee bylaws to require confidentiality and in many cases an order is entered early in the case setting forth guidelines for appropriate, but controlled, information sharing with creditors generally.

Types of case

Although the goal is basically the same in all types of Chapter 11 case – to negotiate with creditor groups and confirm a plan of reorganisation – there are variations between types of Chapter 11 case. These variations fall into three main categories:

- the classic (or 'full-relief') Chapter 11;
- the pre-packaged (or 'pre-pack') Chapter 11; and
- the pre-negotiated (or 'fast-track') Chapter 11.

Two examples of the full-relief Chapter 11 are Kmart and Winn-Dixie. In early 2002 Kmart Corporation and its affiliates collectively comprised the second-largest discount retailer in the United States. The company operated its retail operations through over 2,000 locations, the overwhelming majority of which were leased. It employed almost 250,000 employees, had annual revenue of over $36 billion and was ranked 36th on Fortune's list of the 500 largest US companies. However, the company had experienced declining sales as a result of stiff competition from Wal-Mart, Target and other retailers. It had particularly poor holiday results for the 2001 holiday shopping season, resulting in insufficient liquidity to pay large amounts of trade payables that had accumulated in connection with its build-up of inventory in anticipation of the holiday season. The company, its board of directors and the Securities and Exchange Commission also

received anonymous letters, purportedly from employees, alleging malfeasance in connection with the company's accounting and financial reporting practices.

These events in combination caused Kmart to file bankruptcy in January 2002. Kmart was the largest retailer ever to attempt to reorganise its affairs under Chapter 11 of the Bankruptcy Code. During the course of its 15-month stay in bankruptcy, the company exhaustively analysed its store base as part of a comprehensive store rationalisation programme. Ultimately, the company closed approximately 600 underperforming stores and disposed of the related leases. It also undertook a major internal investigation of the matters related to the anonymous letters and assisted various governmental agencies in their separate investigations of the company. As a result of these investigations, numerous employees were separated from the company and new management was put in place. Under Kmart's reorganisation plan, ESL Investments, Inc, one of the company's largest unsecured creditors, invested significant sums in the reorganised company and converted its debt to equity, thereby acquiring control of the new enterprise. In the process, Kmart shed approximately $8 billion in unsecured debt obligations. Subsequently, ESL acquired Sears and merged the two companies into Sears Holdings.

Winn-Dixie is a well-known large supermarket chain that was battered by competition from discounters such as Wal-Mart on the one hand and upscale supermarket chains such as Publix on the other. In early 2005 it suffered a liquidity crisis when its trade creditors suddenly reduced its available trade credit and it was soon forced to file a Chapter 11 case with little opportunity to prepare an exit strategy. Once in Chapter 11, however, Winn-Dixie undertook a comprehensive review of its entire operational structure and business model, with the goal of identifying its strengths and weaknesses. The resulting business plan called for it to exit unprofitable markets in Virginia, North and South Carolina and Georgia, and to close a variety of satellite food manufacturing businesses. This plan, which required the rejection of hundreds of leases, could only have been executed employing the comprehensive lease rejection provisions contained in Chapter 11. Having decided which locations to close, Winn-Dixie ultimately rejected over 450 leases on which it owed payments exceeding $175 million per year. Less than two years after commencing Chapter 11, Winn-Dixie successfully emerged from Chapter 11, having implemented a comprehensive business turnaround that could not have been achieved outside of Chapter 11.

Another type of Chapter 11 that has received a great deal of favourable attention is the so-called 'pre-pack'. In a pre-pack the votes of affected creditors are solicited prior to filing the Chapter 11 case and the company commences the Chapter 11 filing with its exit strategy – and the votes necessary for plan confirmation – already in place. These cases are quick – recent cases have lasted from one day to a few months – and much less expensive and time consuming for management than traditional Chapter 11 cases. However, the inherent limitation of a pre-pack relates to the scope of relief that is available: most cases restructure only public debt because that is the debt best able to be solicited pre-petition in the form of an exchange offer. More recently, however, experts have recognised that pre-packs also can be an effective tool for use with secured creditor groups that contain lenders which have adopted a confrontational position in an effort to compel the borrower to make extraordinary concessions to the lender. This was the situation in the recent *Blue Bird Case*, in which a one-day pre-pack forced the lone dissenting member of a secured bank group to accept a plan to sell the company. This secured creditor had refused to approve credit agreement amendments that would have allowed an out-of-court restructuring of the company, but its dissent was overridden by the bankruptcy law provisions which bind all creditors once a sufficient majority of creditors in a class agree to a plan proposal.

Of course, the fact that a pre-pack typically affords more limited relief than other alternatives is immaterial if, for example, a company needs only to restructure its public debt. However, if a company requires a major operational restructuring and must renegotiate major contracts, reject numerous leases or reduce embedded legacy costs, then a pre-pack will not afford it the relief that it needs in order to regain full economic health.

Recently, however, a technique has been refined that combines the benefits of a full-relief Chapter 11 and a pre-pack: the pre-negotiated, or fast-track, case. Aurora Foods was one such case. Aurora was the manufacturer of an assortment of brand-name foods that included Mrs Paul's frozen fish sticks, Aunt Jemima syrup and Duncan Hines cake mixes. Notwithstanding the name recognition of many of its brands, it had been plagued by scandal and had an unsustainably high level of public debt that

severely limited its operational flexibility. Although it also had trade debt, specific federal statutes that give special treatment to vendors of fresh and unprocessed foods meant that little could be done restructure this debt.

The answer for Aurora was a Chapter 11 case that lasted about two months from its inception to plan confirmation. A comprehensive agreement with secured creditors and an asset purchaser was negotiated before the company filed for Chapter 11, as was an agreement with trade suppliers that gave them special treatment if they continued to ship on normal terms. All that was left to do when Aurora filed for Chapter 11 relief was to send the Chapter 11 documents to creditors and then present to the court the terms of the plan and its acceptance by creditors, so that the court could confirm the plan. Of course, there were creditors seeking to leverage their dissent into more favourable treatment, but the court rejected their arguments and the plan was confirmed shortly thereafter.

NRG Industries, one of the world's largest independent power generation companies, had an experience similar to Aurora's. For about nine months before it filed, NRG worked on a business plan and operational improvements. It then filed a Chapter 11 case seeking approval of its pre-negotiated plan, which proposed to convert to equity about two-thirds of its debt. In addition, by selling unneeded assets it was able to retire $1.2 billion in debt and more than double its cash in hand. It completed its restructuring, confirmed its plan of reorganisation and exited Chapter 11 approximately six months after the case was filed.

It is this latter type of case – a case in which management has taken significant steps to develop a restructuring plan before the Chapter 11 case is filed – that may be the wave of the future. This is particularly the case because of two recent changes to the bankruptcy laws that set important deadlines much earlier in a case than before. The first change relates to the time within which a debtor must decide whether to assume or reject real estate leases. Prior to such changes in the law, a debtor could continue to make lease payments but wait until as late as plan confirmation to decide whether to assume or reject a lease, and many debtors availed themselves of that flexibility. This flexibility could be particularly important where a debtor was seeking to implement an operating turnaround and needed time to assess whether it was profitable to retain a particular location. Now, however, unless the landlord agrees to an extension, there is a 120-day deadline after a case is filed to make that decision, although the court can extend that period to a total of 210 days if there are valid grounds. Although the earlier law technically set a 60-day limit to decide whether to assume or reject a lease, the date to make a decision could be, and often was, extended to confirmation of the plan of reorganisation.

The second change made in the bankruptcy laws relates to the time in which a debtor alone has the sole right to propose a reorganisation plan. When a Chapter 11 case is filed initially only the debtor has the right to propose a plan of reorganisation. This right is generally considered to be of great importance to a debtor maintaining control of its Chapter 11 case, since otherwise any party could draft and file with the court a proposed plan of reorganisation, whether acceptable to the debtor and its management or not. Uncontrolled plan filings could easily create the perception of chaos on the part of both customers and vendors, since, whether confirmed by the bankruptcy court or not, such plans could propose radical alterations in a company's business that could well alienate key constituencies. Thus, the outer limits of exclusivity operate in most cases as a practical timetable for a Chapter 11 case. Considering that LTV was in Chapter 11 for seven years, Johns-Manville was in Chapter 11 for six years, AH Robins was in Chapter 11 for over four years and Federated Stores was in Chapter 11 for two years, it is clear that this time limitation represents a significant change in the law.

The practical effect of these changes will operate in most cases to accelerate the pace of the Chapter 11 process. A company now has approximately seven months after a petition has been filed to decide what markets it will exit if it wants to take full advantage of the Bankruptcy Code's limitation on lease rejection damages. This means that, unless the company has made meaningful progress in thinking through its restructuring strategy before it files for bankruptcy, it could lose one of the significant benefits available in Chapter 11.

However, it may well be a positive development for many companies that these deadlines will facilitate a more expeditious process, allowing for a relatively rapid exit from Chapter 11. Indeed, while Chapter 11 provides companies with a fresh start and breathing space, it does not immunise the corporation from either macroeconomic, industry-wide or company-centric event risks, which can and have derailed otherwise meticulously planned and executed restructurings.

On the other hand, failure by management and a board of directors to recognise in a timely manner critical operational or financial issues and begin contingency planning for a possible filing may well impair the ultimate success of the reorganisation process.

What, then, are the implications of these issues for an informed chief executive officer? At minimum, there appears to be little or no doubt that companies facing severe economic crisis will enhance their chances of achieving an optimal solution to whatever financial crisis they may be facing by identifying their problems sooner rather than later and beginning to plan accordingly. Experience has shown that companies that delay unduly in recognising and then planning for a crisis are less likely to achieve the maximum benefit of a Chapter 11, compared to companies that are proactive in recognising the fact that deteriorating financial prospects may well require resort to Chapter 11. Hoping for the best while planning for the worst invariably proves to be a prudent and value-enhancing strategy.

Conclusion

The chances are high that a US traveller's next flight will involve an aircraft flown by a company that has become competitive by using the tools of Chapter 11. On returning home from the airport, he or she might pick up groceries from a Winn-Dixie store or other items from a Macy's or Bloomingdale's, all of which revitalised their businesses in Chapter 11. When turning in for the night, he or she might be wearing sleepwear by Warnaco, a Chapter 11 turnaround, and sleeping on WestPoint Stevens sheets, manufactured by a former Chapter 11 company. These familiar names from the corporate United States illustrate compellingly that Chapter 11 is indeed merely an attack from a different direction, rather than surrender. While restructuring a distressed business out of court may well be the preferred or even optimal path, many stakeholders compare proposed out-of-court solutions with predicted in-court recoveries when assessing how to respond to a company's restructuring efforts. An informed and proactive chief executive officer must know the calculus being considered by the company's stakeholders, which requires at least internal evaluation and assessment of the company's strategic alternatives, including Chapter 11. Understanding these alternatives may well lead to an educated and reinforced determination to consummate an out-of-court restructuring. Alternatively, if Chapter 11 becomes the preferred path, the company's preparation should maximise its management team's ability to execute a well-financed, well-planned and well-managed Chapter 11 reorganisation successfully.