Restructuring Debts In and Out of Court

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There are many reasons why a company may become financially distressed. Once it reaches a point of insolvency, however, management may consider a restructuring of the company's financial obligations in order to restore the company back to financial health. The restructuring could proceed informally, through a consensual restructuring, or through of a court-supervised reorganization under chapter 11 of the Bankruptcy Code. In most instances, the distressed company should first attempt to negotiate a consensual restructuring of its major obligations.

> Out-of-Court Restructuring

An out-of-court restructuring or "workout" is a nonjudicial process through which a financially troubled company and its significant creditors reach an agreement for adjusting the company's obligations. A successful workout generally requires the participation of the company's lenders, major suppliers, and depending on the circumstances, other organizations or entities such as unions or governmental agencies. Identifying and agreeing on the source of the company's problems and the potential solutions may take time. Indeed, it is not uncommon for the company's management to hold a different impression of the company's financial problems than the one held by the company's creditors.

Any restructuring entails substantial demands on the time of the company's management. In a workout, management must focus primarily on devising a viable restructuring plan and preparing a business plan and supporting projections, which likely will need to be presented to creditors. Management also will be involved in negotiating the terms of the agreed restructuring plan and, further down the line, on implementing such plan.

When successful, a consensual out-of-court restructuring signifies a willingness by the company's creditors to work with the company to solve its financial problems. It similarly reflects a judgment by knowledgeable parties that the company can be put on sound footing outside of bankruptcy. More importantly is the fact that a workout can usually be accomplished more quickly than a chapter 11 restructuring.

One factor that strongly influences the extent to which creditors are willing to compromise out of court is the company's ability to commence an in-court bankruptcy proceeding. Because workouts must be viewed against the backdrop of a potential bankruptcy filing, each interested party is compelled to evaluate whether an out-of-court restructuring is more favorable than the likely outcome in a bankruptcy case. Creditors and equityholders must keep in mind that, if a bankruptcy case is filed, they generally lose some bargaining strength, as they become subject to the authority of the bankruptcy court and the provisions of the Bankruptcy Code allowing nonconsensual modification of claims and interests. Many times, it is the company's ultimate threat of filing bankruptcy that forces the parties to an agreement.

> In-Court Restructuring

Unlike the consensual out-of-court restructuring process, chapter 11 forces all creditors and equity interest holders into a public, court-supervised forum that must proceed according to an intricate set of rules under the Bankruptcy Code. By way of example, any activity of a company in bankruptcy that is not in the ordinary course of business or any settlement by a company with its creditors must be approved by the bankruptcy court, after notice to all interested parties. One or more of the interested parties, whether they are not a party to the transaction itself, has the opportunity to challenge the proposed initiative or settlement.

During a bankruptcy reorganization under chapter 11, the company normally continues to run its business as a debtor-in-possession. However, the management may owe fiduciary duties to the company's creditors, once the company becomes insolvent and proceeds down the path of chapter 11. In contrast, when a company is solvent, management normally only owes a fiduciary

to the company's shareholders. As a result of this shift in duties, it is sometimes difficult for management to identify predominantly where its obligations lie.

In chapter 11, the company's obligations are restructured pursuant to a plan of reorganization, if such plan meets the numerous requirements under the Bankruptcy Code and is approved by the bankruptcy court. Among other things, the plan must provide that each creditor receives at least as much as it would have received in a chapter 7 case unless the creditor agrees to a different treatment. There are also two paths to confirm a chapter 11 plan, consensually or through "cram down." A consensual plan is one in which all classes of impaired creditors vote to accept the plan. If one class rejects the plan, the plan can still be confirmed pursuant to certain provisions of the Bankruptcy Code. This latter approach is commonly referred to as a "cram down."

There are situations in which restructuring in chapter 11 is the best option for a troubled company. One such situation arises when the company faces numerous lawsuits or a judgment that could destroy the company's business. In such instances, the company is likely to obtain relief by filing for chapter 11, in order to obtain the benefit of the automatic stay, which is akin to a statutory injunction imposed in favor of the company against all creditors.

Chapter 11 also can improve a company's immediate cash position. When a company enters bankruptcy, it is generally prohibited from making payments on pre-bankruptcy obligations. In addition, interest ceases to accrue on the unsecured and undersecured debt of the company. As a result, the company's cash flow often improves after commencing a bankruptcy case. The Bankruptcy Code also provides mechanisms under which a debtor can obtain financing after its bankruptcy filing. Among other things, the Bankruptcy Code allows a lender to obtain superpriority liens and/or claims against the company's assets. These special protections serve to encourage lenders to provide funding that they otherwise might not provide outside of bankruptcy.

Chapter 11 further provides a company with broad powers to renegotiate its contracts and leases. Under the Bankruptcy Code, a debtor or trustee can reject or assume a contract or lease, or can assign the contract or lease to a third party, despite contractual provisions prohibiting such assignment. Implicit within this authority is the ability to modify existing contractual terms.

> Prepackaged or Prenegotiated Plans of Reorganization

Recognizing the benefits and drawbacks inherent in both the workout and chapter 11 scenarios, parties have availed themselves of procedures that facilitate obtaining the best of both worlds while minimizing their respective disadvantages. In prepackaged chapter 11 cases, the company negotiates a plan of reorganization and solicits votes on its plan before the commencement of its bankruptcy case. In this fashion, the company can obtain the benefits of both a workout and the chapter 11 process, while significantly reducing the amount of time spent in bankruptcy. For example, in the case of CIT Group Inc., the $70 billion financing company spent approximately 40 days in bankruptcy, because it was able to negotiate, and obtain wide creditor approval of, its prepackaged plan with its major constituencies prior to filing. The plan itself reduced CIT's total debt by approximately $10.5 billion, while deferring other debt maturities for three years and enhancing its capital ratios to levels that exceeded regulatory requirements.

A company may secure the votes of creditors prior to filing bankruptcy through a plan support agreement, commonly referred to as a "lock-up" agreement. A lock-up agreement between a creditor and a company is an agreement whereby the creditor becomes legally bound to vote for the plan of reorganization so long as certain key plan provisions are included.

In addition to prepackaged plans, another framework that is used with frequency is the "prenegotiated" chapter 11 plan. Similar to a prepackaged case, in a prenegotiated case the company negotiates with its major creditor constituencies and knows what groups tend to support its plan prior to filing bankruptcy. Unlike a prepackaged case, however, the company does not begin the creditor approval process on its plan until after it has filed bankruptcy and obtained the bankruptcy court's approval of its solicitation material. Although prenegotiated cases may last a little longer than prepackaged cases because the solicitation process occurs post-filing, prenegotiated cases still expedite a voluntary reorganization under chapter 11.

Restructuring Debt

One significant factor that has caused companies to start negotiating with creditors earlier than in the past is the new limitation on a company's ability to exclusively propose a plan of reorganization during a bankruptcy case. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) limits the time period in which a company has to propose its chapter 11 plan. A company now must propose its plan within 120 days of filing or risk losing the exclusive right to propose such plan to other interested parties, like lenders or committees. For cause, the bankruptcy court may extent the company's exclusive period for up to 18 months. A survey of the significant bankruptcy cases filed after BAPCPA reflects that many companies have chosen to negotiate their restructuring plans well before filing bankruptcy, thereby allowing them to obtain approval of their plans almost immediately after filing. Recent examples, like CIT, General Motors, Chrysler and the Texas Rangers, also suggest that this appears to be the trend.

> Conclusion

Whether there is time and available resources to achieve a successful out-of-court restructuring will depend on the circumstances. What is certain is that in almost all instances careful planning and coordination with experienced counsel and advisors will be required. Even in cases where an out-of-court restructuring is not a viable option, a chapter 11 reorganization still entails consideration of a substantial amount of factors. This is even the case when a company is pursuing a prepackaged or prenegotiated plan.

If you have any questions regarding the information contained herein, please feel free to contact the Looper Reed attorney with whom you work.

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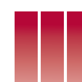

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