FACTORS THAT DRIVE THE USE OF CHAPTER 11 IN RESTRUCTURINGS

By Steven Strom

When a company acknowledges the necessity of a balance sheet restructuring, people often ask, "Can a restructuring be completed without an in-court bankruptcy"?

The answer, of course, is yes.

Many forms of restructuring do not contemplate the use of bankruptcy court to implement a restructuring. For example, turning around a business by reducing costs, divesting underperforming assets, or changing the marketing approach are strategies that do not involve the in-court process of Chapter 11. Liability management transactions (where debt is exchanged for other debt and/or new money is raised) are another frequently used tool that does not involve Chapter 11.

When the strategy is to equitize debt, however, the answer can be more nuanced. How many lenders and layers of debt might be involved? What are the costs and benefits of in- versus out-of-court? In some cases, a single factor may drive the decision of whether to use the bankruptcy court, or the decision may be driven by a particular group of stakeholders.

Here are some of the major drivers in considering whether using bankruptcy is an appropriate tool:

1. Liquidity and access to new capital - For companies that require additional capital to make essential payments (e.g., salaries, wages, and related taxes), debtor-in-possession ("DIP") financing may be the only avenue to obtain funds on a timely basis. DIP financing is usually obtained from existing secured lenders upon filing of a Chapter 11 case. When existing secured lenders won't allow other capital providers to prime their liens out-of-court (even if money is being offered by a third party), bankruptcy may be the only path available to obtain necessary funding.

2. Consensus - Do all the lenders agree and support the form of restructuring? More specifically, how much debt will be converted into how much of the equity? If all the lenders do agree, then an in-court bankruptcy may not be necessary. However, if there is disagreement, having the support of only 2/3 of a given class of creditors in bankruptcy can enable binding or dragging along the dissenters. This also leads to a related issue—what about the shareholders?

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3. Cram down - It is difficult to give out-of-the-money constituents a recovery when senior creditors are not being paid in full. In these cases, the bankruptcy code enables a company to cram down (give zero) to a group (provided other bankruptcy code tests are satisfied).

4. Contract rejection - When a company has an uneconomic contract, it may try to renegotiate new terms out-of-court. In bankruptcy, however, the company can reject executory contracts in their entirety. The threat of rejection in bankruptcy can also provide a company with leverage to negotiate a more favorable outcome out-of-court.

5. Asset sales - While companies can sell assets outside of bankruptcy, this likely requires secured lenders to release their liens. Also, many purchase agreements include representations and warranties that are expected to survive the transaction; however, in the event of a subsequent bankruptcy, those rep and warranty claims may not be paid in full, thereby complicating negotiations. In Chapter 11, debtors have the ability (subject to court approval and a relatively transparent process) to sell assets free and clear of all liens.

6. Taxes - Converting debt to equity can cancel debt income, which can result in cash income taxes payable. The tax bill can be offset in part or in whole with net operating losses (NOLs); however, in certain instances, tax planning can be a driver of the reorganization mechanism used to implement a restructuring.

7. Releases - Out-of-court transactions do not provide a stay against litigation, and relevant parties at a company may find themselves defending their actions by litigious creditors and other stakeholders. While sometimes controversial, courts can provide releases of claims and exculpation that may be more challenging to obtain in out-of-court transactions.

8. Business impact - Will Chapter 11 materially impact operations or contracts? For some companies, Chapter 11 doesn't necessarily impact the operations, while a lengthy process can adversely affect others. Also, investor and stakeholder perceptions of an insolvency process may differ for non-US operations and especially for directors of foreign subsidiaries in jurisdictions where local laws attach personal liability for operating while insolvent.

9. Cost - Chapter 11 can be costly, and careful planning is necessary to minimize the time spent in court. While some venues may offer speedier processes or fast-track procedures for large, complex cases, the cost is a major factor often negotiated with impaired creditors who may be needed to obtain DIP financing.

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Restructuring does not mean bankruptcy, but bankruptcy does offer powerful tools that can address many (but by no means all) problems facing a distressed company. After a restructuring, there will still be issues of selecting the right team, establishing new governance, addressing material weaknesses, and regaining the trust and confidence of a wide range of stakeholders.

Careful consideration of the factors listed here, as well as understanding the unique aspects of the business, can help a board of directors plan the best path and highlight the possible need for contingency plans. An engaged and knowledgeable board, working with advisors experienced in both in- and out-of-court solutions, should be able to present a credible and efficient path to a restructuring to creditors and collectively move to put that plan into effect.

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