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Expert Analysis

The Role of Chapter 11 in Today's Economic Climate

By Jonathan Carson

In the current economic environment, business leaders, policymakers and government officials face daunting challenges to restore stability to the U.S. and global economies. During these troubled times, they turn to Chapter 11 bankruptcy as a strategic alternative with hopes of returning to profitability, and the significant increase in filings in recent months illuminates this growing trend.

For the year ending with Q1 2009, statistics from the Administrative Office of the U.S. Courts showed a 69.1 percent jump in Chapter 11 filings in comparison with the same period for the previous year. A recent study released by Dun & Bradstreet predicts another wave of bankruptcies to occur in the second half of 2009, with a forecasted 60 percent increase in Chapter 11 filings over the present number of filings.

While many spectators forecast doom and gloom for companies that file for bankruptcy protection, Chapter 11 provides a path to successful recovery for many troubled businesses. The challenges of the current economic climate raise questions as to the restorative powers of Chapter 11. Can Chapter 11 continue to give distressed companies a new beginning? Examples from the past and the present indicate that Chapter 11 remains a powerful strategic tool for corporate entities seeking to restructure a balance sheet and/or navigate operational challenges.

The bankruptcy filings of Chrysler and General Motors provide notable examples of the power of Chapter 11 to tackle the specific issues and needs of an industry in peril. These cases represent a new “hybrid” of bankruptcy with an unprecedented level of government involvement in corporate restructuring, setting precedent for other companies that are considered “too large to fail.”

While the reconstituted automakers have much work to be done following their emergence from bankruptcy, Chapter 11 has served as an effective strategic platform for the industry to get back on its feet to face these challenges ahead.

In the current downturn, companies of all industries and sizes have used Chapter 11 to preserve corporate value. Many business leaders are turning to Chapter 11 as a strategic vehicle to shed assets free and clear of liens under Section 363 of the U.S. Bankruptcy Code.

Section 363 asset sales provide distressed companies and their lenders with a more effective mechanism for selling assets than traditional state foreclosure laws. Recent data from Bankruptcydata.com indicate that more than 25 of the country's largest bankruptcy filings that occurred this year involved a Section 363 asset sale as part of the proceedings, including General Motors, Chrysler, Lyondell Chemical Co. and Nortel Networks.

Furthermore, across the globe, many countries inspired by Chapter 11 and by the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency have devised new laws to embrace a "corporate-rescue" approach that aids distressed businesses. Companies in the United Kingdom, France, Germany, Spain and Italy, among many others, increasingly turn to these regimes' corporate-reorganization procedures as strategic alternatives to preserving value.

Track Record of Chapter 11 Success

In gauging the restorative role of Chapter 11 in the current economic climate, we can look to lessons from the past. Congress revamped the Bankruptcy Code in 1978 to provide a viable path for companies seeking to cleanse balance sheets and overcome operational challenges. As a result, companies have relied upon and benefited from proper use of this strategic platform over the past three decades.

In past industry-wide recessions, leading companies have navigated difficult times by using Chapter 11, emerging stronger, leaner and more competitive. For example, in the mid-1970s the steel industry suffered from lower-cost competition, mounting overcapacity and enormous pension obligations due to its aging and retired workforce. Chapter 11 enabled steel-industry giants to effectively downsize their debt and pension obligations in keeping with the needs of its employees, resulting in a more stable industry.

Looking to the present, some industry analysts have deemed the Chrysler and GM filings as the most successful restructuring efforts in U.S. business history. Chrysler's bankruptcy lasted a short 36 days, followed by GM's expeditious Chapter 11 case, lasting a remarkable 40 days. To be sure, challenges remain for these automakers.

The "old GM," now known as Motors Liquidation Co., may take years to dispose of its nonperforming assets. To state that GM truly has emerged from bankruptcy would therefore be misleading. Its unsecured creditors and bondholders will continue to negotiate over recoveries from the bankruptcy estate, and it must

still wind down or sell its underperforming brands. The fate of certain GM manufacturing plants and the matter of its environmental liabilities also remain for determination in bankruptcy.

Nonetheless, the automakers blazed new trails by leveraging the Bankruptcy Code in creative ways to help them drive forward in their restructuring efforts.

Both cases' rapid progression can largely be attributed to a significant aspect of the proceedings: the government's role as both the financier for the Chapter 11 proceedings and the lender enabling the companies to recapitalize and exit bankruptcy. Section 363 of the Bankruptcy Code also played a critical role in the rapid progression of the proceedings. These combined factors enabled the cases to move with unprecedented speed that surprised even the most seasoned restructuring professionals.

Aside from the automotive industry, other companies are using Chapter 11 in nontraditional ways to maximize corporate value. Chapter 11 has become a common venue for M&A activity as seen in recent transactions. As one unique example, printing companies Vertis and American Color Graphics successfully used Chapter 11 to merge into one profitable entity following their respective, individual prepackaged bankruptcies.

In a court filing, Vertis' lawyers called the deal the "first large (or maybe first ever) 'double-prepack-merger.'" The case provides another example of how distressed companies are taking creative and successful approaches to Chapter 11.

Challenges Facing Chapter 11 in Today's Economy

While Chapter 11 remains a permanent fixture of the U.S. economic culture, the depth and scale of the financial crisis raise questions to whether Chapter 11 can continue to help companies emerge healthier and more competitive. While it can be challenging to obtain debt-or-in-possession financing in the current market, many companies with sound business strategies and supportive stakeholders are able to obtain the capital not only to survive bankruptcy, but to flourish upon emergence.

As the U.S. economy slowly begins to emerge from the financial downturn, viable businesses will have greater access to capital, and many more companies will be able to consummate strategic restructurings.

In addition to the challenges of current market conditions, many restructuring professionals object to certain

provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Unfortunately, these laws have had unintended consequences as lawmakers did not anticipate the negative implications of BAPCPA's business bankruptcy provisions. Moreover, the current economic climate magnifies the impact of these provisions.

For example, the amended lease-rejection language in Section 365(d)(4) of the Bankruptcy Code has created significant challenges for retail companies by limiting the time for them to evaluate their lease obligations. In fact, a recently released survey by AlixPartners indicated that 50 percent of the respondents believe the language in this section is the most pressing area needing reform within the Bankruptcy Code because of the restrictions it places on companies to successfully restructure.

Under Section 365, BAPCPA imposed a 210-day limit on the amount of time allowed for companies to reject leases. Before the economic crisis, this new provision posed fewer challenges as companies were in a better position to conduct adequate pre-bankruptcy planning so that the debtor could restructure its lease obligations under the deadline. With the pressure of today's financial marketplace, retailers are left with little or no time to methodically work through their lease issues and instead are forced into filing Chapter 11 protection without having mapped out the impact of these lease decisions on the overall viability of the business.

Chapter 11 as a Path to Recovery

While economic conditions and BAPCPA have caused new challenges for distressed companies, Chapter 11 remains a viable option for many industries, particularly for companies with strong business models and supportive stakeholders.

Despite challenges in the current economic environment, there have been striking examples of how the Bankruptcy Code can be used effectively with the proper planning and execution.

Within the automaker filings, Chapter 11 has been used successfully and in unprecedented ways. Both GM and Chrysler have been given a new lease on life. In other industries, distressed companies and their lenders can successfully maneuver using prepackaged and pre-arranged bankruptcy to resolve their issues.

Conclusion

In evaluating the value of Chapter 11 in the current economic climate, it remains essential to take a long-

term perspective. Industry analysts predict that credit markets will gradually recover and return to normal lending activity in the next 12 to 18 months. Bankruptcy reform may be on the horizon as restructuring professionals continue to voice objections to BAPCPA's provisions affecting Chapter 11.

In the meantime, companies continue to seek new ways to take advantage of the strategic benefits afforded by the Bankruptcy Code through its many facets and possibilities. As a result, corporate restructuring will continue to serve as a path to recovery for troubled companies seeking renewal and an opportunity to return to profitability.



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