

I N S I D E T H E M I N D S

Trends in Commercial Bankruptcy Filings

*Leading Lawyers on Preparing Clients to File,
Navigating Recent Liquidations and Sales, and
Revising Existing Bankruptcy Strategies*



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Mapping Administrative Strategies to Changing Paradigms of Chapter 11

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Introduction

The Chapter 11 landscape is constantly changing, driven by financial market volatility and fluctuating economic conditions. As a result, Chapter 11 paradigms continue to evolve, presenting new hurdles for corporate restructuring professionals. Given the growing complexities of the Chapter 11 process, corporate debtors and their professionals must anticipate the myriad of administrative challenges within the changing dynamics of corporate bankruptcy. They can more efficiently navigate these challenges by mapping out effective administrative strategies and enlisting technology-based systems and solutions to ensure a smoothly administered case.

Historically, Chapter 11 case administration relied upon antiquated, paper-laden methods and procedures. This imposed significant burdens on corporate debtors and their professionals. In the last ten years, new technology-based processes and practices have emerged within the corporate restructuring space to eliminate inefficiencies and help professionals better manage the process. While Chapter 11 will continue to present new challenges, proper strategy and planning will help to avoid pitfalls throughout every phase of the corporate restructuring process.

We can gain a greater understanding of the administrative challenges of corporate bankruptcy by first examining their context. The evolution of corporate bankruptcy from stigma to strategy, macroeconomic trends, as well as recent corporate restructuring market trends, all have greatly influenced the Chapter 11 administrative landscape. For the purposes of this analysis, we will focus on large-scale Chapter 11 filings, primarily filed by publicly traded companies, as these cases generally present the greatest administrative demands.

The Evolution of Chapter 11 from Stigma to Strategy

Historically, Chapter 11 signaled the downfall of a company. However, over the last twenty years, corporate restructuring has evolved away from the stigma its name carried two decades ago. Today, U.S. businesses use Chapter 11 as a prevalent corporate strategy to preserve market value. Many companies have emerged from bankruptcy protection more competitive and better positioned for long-term growth.

Twenty-five to thirty years ago, it was risky for a CEO to walk into their banker's office and suggest a Chapter 11 strategy, or even mention the word bankruptcy. That has changed—the stigma of corporate bankruptcy has waned. Most corporate restructurings today are strategic in that businesses utilize provisions of the Bankruptcy Code to effectuate necessary change in the business; however, circumstances occur that force a company into reactive, non-strategic bankruptcy filings.

The major corporate fraud scandals in the early 2000s and subsequent Sarbanes-Oxley Act of 2002 provided some historical impetus for companies to consider corporate bankruptcy as not only a fiduciary duty to protect stakeholders from a legal standpoint, but also as corporate strategy. The past success of Chapter 11 in resolving industry-wide recessions—such as those seen in the steel and energy sectors—also gradually led to a more positive perception of corporate restructuring in the U.S. In today's environment, it remains as important as ever to view Chapter 11 as a business strategy offering powerful benefits. Companies with good business models and supportive stakeholders can not only survive bankruptcy, but also flourish upon emergence.

Trends and Developments Affecting the Chapter 11 Landscape

Today, a combination of macroeconomic factors and market conditions continue to drive Chapter 11 trends and developments. The financial crisis, industry-wide restructurings, and the state of corporate and sovereign debt both in the U.S. and abroad all represent important influences on the corporate bankruptcy landscape and process.

Chapter 11 bankruptcy filings increased vertically in the last two years. In looking at large-scale cases that retained a claims and noticing agent, we saw eighty-seven Chapter 11 filings in 2007 followed by an uptick in filings in 2008 with 166 filings. In 2009, filings jumped to 242 cases, with a drop in filings during the second half of the year. From January through June 2010, we have seen fifty-six filings. At the current rate, we can expect 2010 filings to be lower than recent years due to a stabilization of economic factors.

Certainly, the 2008 financial crisis played a significant role in the current corporate bankruptcy cycle. Following the crisis, it became extremely challenging for companies that had regular debt maturities to navigate the

credit markets to secure either refinancing or new financing, and that resulted in an elevated number of defaults and bankruptcies.

The tightened credit markets, high volume of overleveraged corporate balance sheets, continuing high rates of unemployment, and decreased consumer confidence contributed to a peak in Chapter 11 filings in 2009. And while the market then entered a lull in activity, various ratings agencies predict a “Wall of Debt” maturing over the next five years, reaching a peak in 2014. According to Standard & Poor’s (S&P), as of June 2010, U.S. companies had more than \$1.7 trillion in S&P rated bonds and loans maturing between 2011 and 2014. The total amount of debt is expected to climb during the next four years, with the proportion of speculative-grade debt growing. If debt maturities peak as forecasted during a slow economic recovery, this will leave a huge volume of unpaid debt as companies struggle to restructure their balance sheets.

Looking forward, restructuring professionals will be busy because of the “Wall of Debt” waiting down the road between 2012 and 2014. If credit markets are flexible and more open, much of that debt may find a source of refinancing in the marketplace; however, if credit markets tighten or face additional volatility, defaults could rise sharply, followed by an uptick in Chapter 11 filings.

The anticipated lack of refinancing sources for maturing loans has led to a recent trend in the U.S. loan markets: the “amend and extend” transaction (A&E). In A&E transactions, borrowers effectively refinance their revolving credit and/or term loan facilities through loan modification amendments that allow them to extend their maturities on a non pro rata basis with the vote of a majority of the lenders. According to Fitch Ratings, A&E agreements will continue to increase through 2014, contributing around \$135 billion in refinancing to the supply/demand gap and allowing the market to redistribute loan maturities to levels more easily absorbed by traditional refinance sources.

In addition to these macroeconomic factors, the restructuring of the auto industry and its legacy obligations made a significant impact on the U.S. economic landscape. The historic Chapter 11 filings of GM and Chrysler, and sixty auto sector filings during 2009, were unprecedented examples of

an industry-wide restructuring. For automotive companies like GM, there are hundreds of companies that provide equipment and services, and that domino effect was felt across the U.S. economic landscape.

As all of these market forces combine and bring greater challenges to the Chapter 11 process, new technology applications continually have emerged in the corporate restructuring arena to streamline the administrative burdens of corporate restructuring and promote open communication for debtors, creditors, professionals, and other interested parties. Traditionally manual, paper-laden processes and procedures have become streamlined and automated which has resulted in increased efficiency for all market participants.

An Overview of Traditional and Emerging Chapter 11 Paradigms

Changing market conditions and volatility also have contributed to an increase in non-traditional bankruptcies, including a greater number of accelerated bankruptcies, both prepackaged and pre-arranged, and asset sales conducted under Section 363 of the Bankruptcy Code. We have seen Chapter 11 timelines accelerate due to a variety of factors. In some instances, lenders may be unwilling to advance additional funds and therefore will direct a sale under an expedited time frame. Other causes include tightened credit markets making it difficult for companies to obtain debtor-in-possession (DIP) financing—the funding that companies typically require to undergo corporate bankruptcy while continuing normal business operations—and reduced time frames imposed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). We also see a greater tendency for companies to structure a deal prior to initiating a bankruptcy and then navigate the Chapter 11 process in just a matter of months rather than years to minimize cost and disruption to the business.

As we examine how Chapter 11 processes have evolved, it is helpful to review the elements of both traditional and non-traditional corporate bankruptcies, as this can help to provide context and greater insight into their differences. Chapter 11 cases can range in time and structure from expedited and organized to drawn out and reactive.

On one extreme, we see what is commonly referred to as a “workout.” A workout occurs when a company and its stakeholders unanimously agree to alter the balance sheet and its various elements. Because there is unanimity among creditors, there is no need for Chapter 11 to alter the rights of any party involved; however, because unanimity is required, this form of corporate reorganization is far less common.

At the other extreme, we see what is known as a “freefall” or a “traditional” Chapter 11, where the company reactively initiates a Chapter 11 proceeding either due to pressing liquidity constraints, or a business or operational need for a restructuring. Typically, these filings can be labor intensive and require a lot of scrambling by all parties involved. More often than not, these cases take longer to work their way to completion and end up costing more for those involved.

In between these two extremes, we see a variety of other approaches, including prepackaged and pre-arranged bankruptcies. With a prepackaged bankruptcy, the debtor negotiates its reorganization plan with its creditors, arranges DIP financing, if necessary, and solicits votes on the plan all before filing for Chapter 11. Upon filing, the debtor presents its proposed reorganization documents, such as the Chapter 11 Plan and Disclosure Statement, as well as the results of its pre-petition solicitation of creditors’ votes, and seeks court approval within a matter of days, weeks, or months of the filing depending on the circumstances of the case.

Another approach is a pre-arranged or “pre-negotiated” filing, where the debtor confirms acceptance of proposed terms by relevant stakeholders, but uses the Chapter 11 process to deal with limited operational challenges or to cram down potential hold-outs. In this case, the debtor files its proposed reorganization documents and seeks court approval to solicit creditor votes on the proposed plan with a hearing to confirm the plan that is scheduled typically for a matter of months after the filing date. While not as quick as a prepackaged Chapter 11, pre-arranged cases are expeditious and allow the debtor to exit Chapter 11 within a defined horizon upon entry to minimize cost and disruption to the underlying business.

We’ve seen many more prepackaged and pre-arranged Chapter 11 filings in the last few years in large part due to the scarcity and increased time

restrictions of DIP financing. As capital markets tighten, DIP financing becomes more expensive and harder to find. With decreased liquidity in the marketplace, lenders are reluctant to invest in an open-ended, lengthy Chapter 11 process, as often the longer the company spends in bankruptcy, the greater the cost can be.

Prepackaged plans often allow companies to negotiate with creditors and stockholders outside of court, and save millions they would have spent in court on accounting and legal fees, thereby increasing potential recoveries. Therefore, if unable to secure DIP financing for a traditional bankruptcy, a distressed company may negotiate with its lenders to obtain DIP financing for a prepackaged bankruptcy, or find other distressed investors who want to invest money into the company and recover value through an accelerated bankruptcy process.

Alternatively, distressed companies and their lenders may hire an investment banker and sell the business under a Section 363 asset sale. This section of the U.S. Bankruptcy Code allows for asset sales “free and clear” of liens and has been increasingly used during the peak of the economic recession as a method for ailing companies and their lenders to maximize recoveries.

In addition to the limitations of DIP financing, BAPCPA has imposed reduced time frames on certain parts of Chapter 11. Under pre-BAPCPA laws, debtors were granted the first 120 days to file a Plan of Reorganization with exclusivity granted for months or even years. Changes to the law now cap debtors’ exclusivity to 180 days after the date of the order for relief, limiting extensions to exclusivity to a maximum of eighteen months. Debtors also now have a shorter time frame under which to assume or reject real-property leases—120 days with a ninety-day extension. Previously, debtors were granted a sixty-day period with extensions routinely approved by the court. This increases pressure on the debtor, particularly in the retail sector, to more quickly assess the value of their various locations.

Furthermore, increasingly complex capital structures complicate the dynamics of restructuring, and bring with it greater administrative complexity. Twenty years ago, a company would have one bank that they

owed money to—i.e., their senior secured creditor—and they might have some bonds and some trade debt, such as money that they owed to their trade vendors on a regular basis. Now, however, many companies have first lien debt, second lien debt, and subordinated debt, and there are many different tiers in that capital structure. Consequently, there is often more tension between companies and creditors, and that has changed the dynamic of how these businesses get reorganized. During the corporate restructuring process, these lenders may have conflicting objectives in determining the optimal outcome for the Chapter 11 plan and this can lead to greater conflict among creditors and the company.

Administrative Strategies to Keep Pace with the Evolving Chapter 11 Process

As the bankruptcy process evolves due to fluctuating economic factors and corporate restructuring market trends, it becomes increasingly important for corporate restructuring professionals to anticipate and plan for the administrative strategies to ensure a seamless and efficient Chapter 11 process.

With today's accelerated bankruptcy filings, technology plays a significant role in meeting the administrative demands of case filings. Many corporate entities have more than one company in bankruptcy—in fact, a company that has hundreds of corporate entities in bankruptcy is not uncommon. Being able to file hundreds of Chapter 11 petitions at one time can be time consuming; therefore, having a technology-based administrative platform in place can help to handle the filing process more efficiently by centralizing access to the necessary data and documents for all involved parties.

With the shortened time frame of today's bankruptcies, the importance of pre-petition preparation and efficient case administration is greater than ever. A technology-enabled approach to the demands of case filing and administration can create significant time and cost savings for the debtor and its professionals, particularly when it comes to first day noticing strategy and efficient case administration.

It is important for professionals to provide thorough first-day noticing to ensure that all potential creditors are given proper notice, and to avoid

unexpected parties and creditors from stepping forward with claims once a case is underway. In recent pre-packaged cases, the professionals and claims agent avert these issues by mapping out a comprehensive noticing strategy to all of its potential creditors and ensuring that the necessary data and technology systems are in place so that noticing can progress quickly and smoothly.

To further ensure a streamlined process, efficient case administration must begin before filing. This ensures the implementation of pre-filing administrative procedures, such as setting up case-specific Web sites and technology-enabled call centers. Professionals can ensure that data is organized and accessible to all involved parties, so that they can focus their limited time and resources on the substantive matters of the corporate restructuring process. These measures ensure that key data and documents, such as claim forms, creditor matrixes, important court dates, and contact information are available online. A technology-enabled approach to accelerated bankruptcies can support all aspects of the process, as it promotes open communication and enables data to be available at one point of access so the process can move forward more expeditiously.

Professionals must also plan ahead to ensure administrative procedures are in place to meet case milestones under an abbreviated process. Shortened bankruptcies require sophisticated planning, ensuring that administrative processes happen in proper sequence and at the right time. For example, there are strategies that debtors can undertake to provide greater flexibility during the voting and solicitation period to accommodate an accelerated process. In some cases, the shortened time frame of the case requires the debtor to send out ballots before the claims bar date as the company does not have the full picture of claims exposure when assigning voting classes and amounts. A rolling record date allows the debtor to assign voting amounts and classes and generate ballots on a daily basis for claims as they are filed.

Anticipating and Avoiding Public Securities Pitfalls

Tightened credit markets, complex capital structures, and the accelerated time frames of today's bankruptcies also require professionals to have a

well-executed strategy to reach out to public securities holders as creditors. Many professionals underestimate the potential complications that can result when debtors do not have a strategy in place for dealing with their public securities holders—such as bondholders—when administering Chapter 11 restructurings involving publicly traded securities. Therefore, it is important to make sure that you have the appropriate team in place to keep the restructuring process on track.

Public securities holders hold their securities in either “street name” or as registered holders. Registered holders hold securities in their own names as found in the transfer agent records for equity holdings and with the trustee for bond holdings. When held in “street name,” the security is held in the name of the broker or bank and the underlying holder remains anonymous. During corporate bankruptcy, these public-securities holders often are accessible only through a labyrinth of third-party channels, including agents, brokerage firms, and the Depository Trust Company, the securities depository for U.S.-based securities. As a result, it is critical that debtors and professionals create an action plan to reach out to them at key milestones within these proceedings.

At each stage of the Chapter 11 process, debtors must maintain open communication with public securities holders through the proper channels. At the time of filing, debtors must identify public securities holders and research known holders through a variety of listings and filings. Throughout the proceedings, debtors must provide notice of case developments to the public securities holders through appropriate intermediaries. In preparation for solicitation and balloting, the debtor needs to plan and execute specialized voting procedures and treatment elections and subscription procedures for public securities holder, if needed.

Without proper planning, it would be virtually impossible for debtors to efficiently and successfully conduct key case milestones, such as solicitation, balloting, rights offerings, and distributions when public securities holders are involved. As with other administrative aspects of Chapter 11, technology represents a fundamental aspect of public-securities management and can help facilitate all aspects of the process including

noticing, solicitation, validating, vote tabulation, and even the process of distributing new money and new securities to current investors.

Back to the Basics: A Review of Corporate Restructuring Fundamentals

By more efficiently managing the administrative challenges of today's corporate bankruptcy process, professionals can focus their attention on the substance of the restructuring. Professionals can successfully navigate the tenuous Chapter 11 bankruptcy process by following five fundamental principles of corporate restructuring:

1. *Be Smart.* Corporate restructuring is both an art and a science. Therefore, you must make sure you enlist help from experienced restructuring specialists. From the lawyers to the claims agent, these specialists should have experience in handling the complexities of the entire Chapter 11 process.
2. *Be Quick.* From pre-planning to emergence, companies can achieve their goals in a relatively quick period of time with adequate strategy and agile execution. One of the most important aspects of corporate restructuring is building consensus. Professionals who build consensus will enable their clients to spend less time in bankruptcy, which results in lower costs.
3. *Be Prepared.* Key company information should be accessible to help expedite the process and easily locate required records. Data and other information needed during the process can include financial statements, vendor listings, employee/retiree listings, contracts, real estate leases, etc. The more a company can do to organize information prior to filings, the more they will ultimately save time and money in the Chapter 11 process.
4. *Be Transparent.* It is important to develop a strategic communications strategy to disclose forward progress to relevant constituencies during the restructuring process—from employees and vendors to financial institutions and the media. It is critical that you know what to say, when, and how to say it.
5. *Be sensitive.* When dealing with financial matters of this scale, emotions run rampant. Therefore, you should be sensitive to the needs of stakeholders and provide reassurance that their matter

is one of significance and is being addressed. It is important for the professionals who are working on the case to put themselves in the position of the people who are being impacted.

The corporate restructuring landscape undoubtedly will continue to present new challenges to professionals, based on ever-changing market conditions and economic trends. However, they can better navigate these issues with effective administrative strategies and technology support. In doing so, professionals can anticipate and overcome administrative hurdles and maintain focus on the substance of the restructuring process to ensure a successful outcome.

Key Takeaways

- In recent years, the corporate restructuring process and environment has become more complex due to a variety of economic and market developments, including the financial crisis, overleveraged corporate debt, and continued credit market volatility. These market trends also have influenced the number and types of Chapter 11 filings in recent years.
- Chapter 11 has evolved from stigma to strategy and remains a powerful tool for preserving corporate value. New paradigms of corporate bankruptcy have emerged, with the prevalence of prepackaged and pre-arranged bankruptcies and Section 363 asset sales. Over the years, new technology has emerged to help companies and professionals better manage administrative challenges inherent in large-scale corporate restructurings.
- Given the growing complexities of the Chapter 11 process, corporate debtors and their professionals must anticipate the myriad of administrative challenges inherent in the changing dynamics of corporate bankruptcy. Fortunately, they can more efficiently navigate the process by mapping out strategies and utilizing technology to alleviate administrative burdens and avoid pitfalls throughout every phase of the corporate restructuring process.

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