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Chapter 11 on Decline? Changes Are Here to Stay

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Chapter 11 used to be, to quote Shakespeare, the "be all and end all" for companies either on the verge of insolvency or already bankrupt, and it is still an important tool for many situations. However, the environment appears to be changing for middle-market businesses, those firms with annual revenues between $50 million and $500 million. Only a few years ago, chapter 11 was seen as a significant opportunity for a second chance by enabling the distressed firm to negotiate relief of debt and establish a reorganization and turnaround plan. In some respects, that is still true, but there has been a not-so-subtle shift in attitude about the wisdom of relying on the traditional bankruptcy process vs. many of the emerging trends.


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Over the past several years, a growing number of companies have vigorously sought to avoid the bankruptcy court process and have embarked on such trends as out-of-court negotiations, assignment for the benefit of creditors (ABC) or state receivership and Article 9 foreclosures under the Uniform Commercial Code (UCC) ("friendly foreclosures"). At first glance, one would assume that the cost associated with chapter 11 proceedings is the sole driver behind the resurgent growth of these trends. The impact of escalating costs of bankruptcy proceedings in general and administrative and professional fees in particular cannot be understated, but these are not the only factors driving the search for trends. There are others particularly significant to middle-market companies that are seeking either the opportunity of that "second chance" or exploring the alternatives that provide the maximum benefit to the estate stakeholders. This trend is no longer a trend, but instead a permanent shift to the way insolvency situations are managed in the current and likely future market conditions.

About the Author

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Why Trends Are Here to Stay

One of the major drivers—besides the obvious one of cost avoidance—is the increasing comfort of the insolvency bar with nonbankruptcy solutions. Chapter 11 is no longer the default for middle-market insolvency, a point not lost on all the affected constituents—lenders, investors, vendors and legal counsel—who have been more open to exploring such options as out-of-court restructurings, ABCs, receiverships and Article 9 strategies. Ironically, chapter 11 may itself be one of those drivers to the shift because the impacted constituents seek to avoid the costly intricacies associated with a bankruptcy filing, thereby risking the threat of administrative insolvency outcomes. As a result, many successful legal and financial adviser professionals have found their insolvency skills being applied in alternative environments with the "big stick" of bankruptcy in the background. All of which begs the questions: Which alternative, and why is this not just a cycle?

Analysis of the business' financial condition and the environment in which it operates may determine the best direction for the company seeking its way to a solution. One of the biggest drivers is the advent of special purpose/hedge funds (*e.g.*, distressed debt buyers (collective pools of capital)) available to the lenders of these struggling middle-market businesses. The lenders' ability to easily sell their position, albeit typically at some amount of loss, greatly enhances their ability to gain a recovery sooner than what is typically associated with supporting a turnaround plan and with a certainty to close that is vastly superior. To further enhance this option of selling the debt is the idea of cost savings in maintaining extensive "special asset" internal resources and the costs of reserves—the latter coming under even greater scrutiny given the malaise faced by the financial industry in general. Market maturity has further enhanced the availability of this proc-ess with the more formalized trading of senior debt paper through vehicles such as DebtX and the advent of funds favorable to transactions that previously had fallen below acceptable thresholds. All of these factors serve to enhance the sale of the debt by the senior creditor vs. the alternative of continuing the risk of credit uncertainty, which limits the opportunity for the classic turnaround plan to be effectuated.

The current "lender" landscape also features a number of the higher-risk pools of capital designed to provide high-risk secured loans to companies unable to secure the working capital required for the company's plan. This has often resulted in overleveraged balance sheets with unsustainable fixed charge coverages for the company when the inevitable market downturn occurs. This particular scenario sets the stage for another alter-

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native: the debt-for-equity swap. While this potential solution is not particularly new, it is the readily available size of transactions that fall into the middle- or even lower-middle market situations that has markedly increased, translating to an increase in the appetite for these funds to convert their debt to equity with greater frequency than prior credit cycles. The unregulated fund now has the option of taking a longer view of the company's possible enterprise value over time while still holding a certain amount of senior secured debt and enjoying an eventual equity upside.

In middle-market company situations, there are other drivers besides fear of prohibitive professional fees that induce the apprehension of court proceedings despite insolvency. One that merits serious consideration goes to the heart of every cash flow issue: restoration of liquidity. If emergence from insolvency is viewed as a puzzle, then the advent of liquidity options for lenders for nonpublic debt should be considered an important piece. In many cases, multipurpose and special-purpose funds are in place—a possible solution for seeking secured bank debt, especially if the amount entails a private company loan of no more than $10 million.

Hedge Fund as the Fulcrum

Hedge funds serve a variety of roles within the broad insolvency community and carry great influence both within and outside of the bankruptcy process or on the choice of any potential alternative. Despite their obvious influence, these capital resources represent both a bane and a curse to the process. One example is the selling of senior controlling debt at below-par value. Frequently, this transaction creates difficult negotiations for effectuating the turnaround because the usual incentive is to push the process to a quick sale, thereby achieving a premium return for the purchased debt. Alternatively, these same pools of capital, used strategically, are a resource to achieve out-of-court settlements and other bankruptcy trends, providing the second chance for the company; hence they are many times in a fulcrum position during difficult negotiations. From the fulcrum position, these funds may be viewed as a white knight for companies looking to avoid a § 363 sale under the Bankruptcy Code that is likely to occur in a chapter 11 proceeding.

Here is an example of this alternative in play. A large bank group, fearing that any financial recovery from loans owed by its debtor was limited, moved swiftly to force the company into a § 363 sale, believing that it would result in the maximum recovery of their loans. They were driven by the same typical drivers of the past: speed, certainty to close and recovery. However, a large hedge fund began aggressively buying up the bank debt and eventually securing a controlling position within the large bank group. The fund's position and overall strategy was vastly different than the traditional banks, so it had little interest in conducting the sale. As a result, a reorganization plan was rapidly initiated with the sale process abandoned and ultimately confirmed by the court. The plan resulted in a portion of the debt being converted to equity and the balance remaining as secured debt.

Even when pursuing out-of-court solutions, companies, creditors and investors should consider the use of bankruptcy counsel as a guide through the process. The intricacies associated with insolvency require legal expertise and skilled logic, which are essential for determining whether there is a viable option for restructuring and a subsequent turnaround.

This is a great example of how the hedge fund option is influenced by the approach and time horizon for the hedge funds' hold position and ultimate calculation of return on investment (ROI). It is not uncommon for these hold positions to be longer term, thereby providing the liquidity and time required to effectuate the turnaround plan. Given the hedge fund's position, a longer ROI timeframe is likely to be more acceptable than it would be under the harsh spotlight of an adversarial bankruptcy court case, and this is especially true for the middle-market situations as there continues to be a increasingly greater amount of capital devoted to this segment of the marketplace, which bodes well for a company needing time for its turnaround plan to work.

The roles of the senior secured lender and the junior or mezzanine lender are also factors in the choice of the hedge fund as a company-saving alternative. In cases of liquidation, the priority rule is that dollars go to administration followed by the senior secured lender and the junior secured lender. This largely leaves the unsecured creditors and the company's equity with little to no recovery value. It is here that hedge funds can make a move that may be welcomed by the unsecured creditors. After all, the latter is in no position to make money off what is at its core a nonperforming classified loan. From their vantage point, the unsecured lenders now have an option because the sooner they can recover their loans, the better the chance to put assets back to work on the balance sheet.

A rapidly growing strategic market specializing in the purchase of distressed companies consists of many of the same pools of capital that are interested in buying bank debt. As this market grows, refines and matures, opportunities to utilize nonbankruptcy approaches will increase exponentially. It is not uncommon for these hedge funds to utilize credit and investment facilities, thereby creating a "unitraunche" lender/investor that blurs the line of lender and investor as the fund makes investments into the same company on multiple positions on the balance sheet. Unitranche situations often create a level of practical and legal complexity when the company finds itself in the zone of insolvency or approaching it. As a result, these funds continue to explore ways to deploy capital efficiently and explore opportunities to improve their ROI. The existence of this market may well provide comfort to strategic buyers who may be uncertain long-term about the wisdom of purchasing distressed companies and assets, but recognize that capital needs to work or it provides no return. Market forces by definition will seek out opportunities to do just that with capital, which accounts for the willingness to strategically invest in distressed businesses. The ancient business axiom applies: Higher risk can mean a higher rate of return.

BAPCPA: Unintentional Driver

If there is a classic example of the law of unintended consequences in the business and legal worlds, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) surely deserves this designation. Part of BAPCPA's intent was to significantly decrease the timeline of bankruptcies, since there was no argument that chapter 11 cases tended to drag indefinitely, adding even more costs to an already less than cost-effective process. So what could go wrong for what was supposed to be a chance for corporate salvation?

From the vantage point of unsecured lenders, vendors and investors, the answer is "everything." Although significantly decreasing the bankruptcy timeline, BAPCPA has managed to add significant administrative and professional fees to all bankruptcies, making it difficult many times for a middle-market company to avoid administrative insolvency claims and significantly increasing the odds against confirming a reorganization plan. The additional pressure on constituents due to this short timeframe is an unsustainable environment for most of the parties. Given that scenario, it should not be surprising that companies are more likely under BAPCPA to face a transactional exit instead of transitioning into reorganization and potential profitability. The environment, costs and legal rules dictate the eventual outcome, which is unlikely to be a turnaround.

BAPCPA's emphasis on closure in the quickest possible timeframe has, albeit unintentionally, driven an insolvent business away from a second chance and into an inevitable death sentence: the transactional solution. The 2005 law hastens the demise of long-term turnaround strategies by increasing focus on the obvious short-term responses of sales and liquidation. It is difficult to project how successful reorganizations and turnarounds can be implemented under these conditions. There is little wonder then that BAPCPA has forced the examination by all the case constituents and the related professionals to effectuate a solution outside the halls of justice.

This reality has led to the recognition that these solutions offer a better chance for an out-of-court reorganization for many middle-market distressed companies. A constituent with equity is likely to lose most if not all of it under a chapter 11 filing. Perhaps that is why the "insolvency community" is vastly more attuned to these alternative strategies.

Growing Recognition

Investors and creditors increasingly recognize that consensual out-of-court restructurings of debt accomplish the same task in or out of court. With recognition comes openness to utilize other tools to bankruptcy since constituents are well aware of not only the options but the drivers that have led to their examinations and considerations. Even a carrot-and-stick approach—the possibility of a chapter 11 filing—may bring dissenting minority lenders to the table and result in a more consensual environment than would have been possible with a court case. If that cooperative environment is absent, then chapter 11 certainly offers a prepackaged method to bind dissenting minority constituents, but the outcome for them is often much less than might have been achieved through one of the alternative solutions.

How to Make the Trends Work

Professionals are very aware of the many alternatives to the bankruptcy process: out-of-court restructurings, ABCs, state receiverships and Article IX sales. Each adds its own unique nuances, and certainly pros and cons, to the bankruptcy process. The universal rule, however, to achieving success with any of these strategies begins with Rule One: effective communication among all the parties. All too often, these efforts fail because the needs of some of the parties have either been misread or not fully understood—a prelude to bankruptcy protection if left unresolved. A mutual and collaborative atmosphere, based on credible communication, has to exist if there is any hope of developing a successful nonjudicial strategy.

None of this is to suggest that chapter 11 will or should disappear from the list of choices for the distressed or insolvent despite its challenges. If the climate is combative and there is little in the way of communication or credibility between constituents, chapter 11 may be the only solution despite all the flaws of the process. There will always be situations that demand the structure of the court process, including the automatic stay and forced transparency that comes with it.

Even when pursuing out-of-court solutions, companies, creditors and investors should consider the use of bankruptcy counsel as a guide through the process. The intricacies associated with insolvency require legal expertise and skilled logic, which are essential for determining whether there is a viable option for restructuring and a subsequent turnaround. While chapter 11 remains a valuable tool, it should not be considered the default position for distressed companies of any size, especially for those in the middle market. Its use should be weighed against the situational environment, the depth of insolvency, an evaluation of the viability of out-of-court options, a realistic appraisal of the chances for a successful turnaround and/or the economic benefits of all the possible strategies to the estate. While chapter 11 will not disappear, the current "trends" will not either, and they are now here to stay as part of the insolvency landscape. ■

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