

EXIT STRATEGIES FOR CHAPTER 11 DEBTORS¹

By: **T. Kent Barber (Copyright © 2010)**

This is an advertisement

In today's economy, more and more entities are turning to Chapter 11 to deal with their debts and other obligations. A Chapter 11 allows a company to reorganize and pay creditors over a period of time pursuant to a plan voted on by creditors. The legal process of a Chapter 11 must mesh with the business progress for a successful outcome. Too many troubled business situations are approached without any overall exit strategy. This fact creates unnecessary stress on business owners, and less-than-optimum results. Exploring all possible "exit plans" is something every savvy business owner should be doing from day one, to achieve the best outcome for the particular situation.

The Bankruptcy Code sets forth the prerequisites for Chapter 11 plans to be confirmed. One of the more common, practical hurdles is the cash needed to exit Chapter 11. All postpetition debts must be paid at plan confirmation unless the claimant agrees otherwise. Thus, a Chapter 11 debtor must ensure that it is keeping up with its accounts payable on a monthly basis and determining how any unpaid amounts will be paid before the plan is confirmed. These postpetition debts include fees for professionals (accountants, attorneys, etc.), all amounts incurred after the petition date, and even some debts incurred prior to the bankruptcy (goods received within 20 days before filing). Second, contracts and leases that the company may want to keep will have to be "assumed" at confirmation. Assumption requires that all amounts due under the contract or lease (both prepetition and postpetition) are "cured" (i.e., paid) which normally happens when they are assumed, but may be repaid over some "reasonable" time period. The bankruptcy court will determine what a reasonable time period is under the circumstances if there is dispute. These two types of cash demands can be substantial.

There are other legal prerequisites to plan confirmation, required by the Bankruptcy Code. Creditors are placed in separate classes depending on the type of claim they hold and at least one class of creditors must vote to accept the plan. Many of the provisions in a Chapter 11 plan related to the actual "business plans" are, to an extent, optional and must provide an "adequate means" for implementation or how to repay creditors and emerge from bankruptcy in a "feasible" manner. Normal options that a company will consider as possible exit strategies in Chapter 11 include the following:

Stand Alone Reorganization – Existing Equity Survives

The "absolute priority rule" in Chapter 11 requires that unsecured creditors must be paid in full or the ownership interests cannot survive, unless creditors agree to take less than 100% of their claims. Thus, if the former owners wish to maintain control and ownership of the company post-confirmation, the business projections must show 100% percent repayment of unsecured claims unless "new value" is given (as discussed below) or the creditors vote to agree otherwise.

¹ This article is a service for friends and clients of DelCotto Law Group PLLC. The opinions expressed in this article are intended for general guidance only and not as recommendations for specific situations. As always, readers should consult a qualified attorney for specific legal guidance.

Stand Alone Reorganization - Existing Equity is Wiped Out

If a 100% payment to unsecured creditors cannot occur, the debtor may propose payment to unsecured creditors less than 100% if the interests of former owners are extinguished.

New Equity Holders / Exchange of Current Debt for Equity

Some Chapter 11 plans give the ownership interest in the company to creditors as payment for their claims. In this scenario the “new equity” is allowed to select new board members, officers, and management of the debtor post confirmation.

Stand Alone Reorganization - Equity Survives by Giving “New Value”

In this scenario a debtor may use the judicially recognized “new value exception” to the absolute priority rule. The new value exception allows former owners to infuse new money into the company as part of the plan of reorganization. The amount of money to be paid in is determined by the court, which must find a “meaningful amount” under the circumstances.

Sale and/or Auction Process

In the last number of years, a “363 Sale” has been the exit most commonly seen, primarily because the company lacks adequate cash flow to survive. Under this outcome the company may choose to hire a broker to attempt to sell the company as a going concern or to sell certain assets of the company. The company must take certain steps to ensure that the company’s assets are adequately advertised for sale and the sale is then made to the “highest and best” bidder. “Highest and best” does not necessarily mean the bidder offering the most money. There are many nuances and details to the bidding procedure but it generally begins with an initial bidder (a/k/a “stalking horse” bidder). Other interested parties may then submit bids on the company, usually in an auction setting. Finally, the auction results in a sale to the successful bidder “free and clear” of all claims and liens, with the liens to attach to the sale proceeds, similar to state court foreclosures. Secured creditors genuinely have the right to “credit bid” the amount of their claims (subject to a new controversial line of cases holding otherwise).

Sale to Friendly “NewCo”

A debtor may propose to sell its assets to a newly formed company which often has some relation to the existing ownership or management. “NewCo” offers to buy the assets of the company free and clear of all claims. In this situation, NewCo’s relations with the company must be fully disclosed as to any “insider”, connections, and its offer would remain subject to higher and better offers and heightened scrutiny, by the court because of the relationship with the company’s insiders.

Sale/Hostile “Takeover” Offer is Made

In this situation, a third party buyer negotiates with a secured creditor to get its support for purchase of the company. The third party may then offer to buy all assets and assume the bank debt. The third party may also have other creditors supporting this option. In this instance, the debtor loses control of the case and is forced into accepting this option if no higher and better options are available. This option is more likely to occur if creditors become frustrated with the process and become convinced that the debtor will be unable to confirm a Chapter 11 plan.

It is crucial for any company considering a Chapter 11 bankruptcy to develop an exit strategy. A successful reorganization is most likely when all options have been analyzed prior to the filing of a case. It is hoped that this article assists troubled businesses in considering such options prior to a bankruptcy filing.

For more information about this topic or any Chapter 11 matters, please contact Kent Barber at kbarber@dlgfir.com or any of the other attorneys at DelCotto Law Group.