# WHY REORGANIZATION HAS BECOME A BAD WORD IN CHAPTER 11©

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When I studied bankruptcy law in the 1990s, the idea was a perfected worded plan supported by a beautifully written disclosure statement which restructured the balance sheet of the debtor. At one time the Code was intended to restructure and afford "honest but unfortunate debtor[s]" the opportunity "to start afresh[,] free from the obligations and responsibilities consequent upon business misfortunes." That world is no more.

No more is the model we see in the 2019s where a debtor moves slowly through bankruptcy and plan confirmation serves as the culmination of a court-supervised process from start to finish. Instead, these companies are leveraging mechanisms within the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to their fullest extent and filing "prepackaged" bankruptcies, a colloquial term referring to bankruptcies in which debtors solicit and garner approval of their plans of reorganization prior to filing Chapter 11 petitions. By filing prepackaged cases, these debtors reap many of the benefits of the bankruptcy system while truncating the in-court process, lowering their execution risk, and minimizing bankruptcy costs.

## § 363 OF THE BANKRUPTCY CODE

In a world of liquidating chapter 11 cases and fast sales pursuant to § 363 of the Bankruptcy Code the trend is now to use the Chapter 11 process to quickly sell off assets, pay secured creditors, and avoid payments to trade debt.

Based on empirical evidence companies file prepackaged cases for a variety of reasons. Frequently, debtors seeking to consummate out-of-court balance sheet restructurings turn to prepackaged bankruptcies if they have the support of a majority of their note holders or lenders but cannot reach a resolution with certain holdouts who, outside of bankruptcy, can block such transactions. In those cases, debtors know from the outset that they will have sufficient votes to confirm a plan (see Bankruptcy Code § 1126(c)). For these debtors, a prepackaged filing provides an orderly, efficient mechanism to restructure over the objections of a small number of non consenting parties.

The problem with many prepackaged cases is that the "power" in the process lies with the note holders or lenders and the trade and similar creditors are left with the drippings and crumbs after the main course. Rarely do the trade and similar creditors "ride through" these prepackaged cases and receive full payment on their claims. Rather, the trade and similar creditors have to look to a creditors' committee to prosecute recovery actions in the name of the debtor as a source from their recovery in the case.

## RETAIL PREPACKAGED CHAPTER 11S

In 2018, a significant number of large brick-and-mortar retailers—including Sears, Nine West, Claire's, David's Bridal, Mattress Firm, ShopKo, Gymboree, and Brookstone—filed for chapter 11 protection. Although each case has its own story, the volume and size of these cases reflect an environment in which retailers are being squeezed by online competition, and cannot survive absent significant changes to their business.

In many situations, however, a traditional chapter 11 case would not provide an adequate solution for retailers. Chapter 11 provides important tools to retailers, including the ability to procure post-petition financing and to reject unfavorable leases. But even with those tools, retailers in chapter 11 have had difficulty staving off competitors, reassuring customers, and funding the significant expenses of the chapter 11 process. A basic lesson from recent cases is that, as far in advance as possible—and well in advance of significant maturities—retailers and their creditors should aggressively consider all alternatives to chapter 11. If a filing proves necessary, the downside risks can, in some cases, be mitigated through a quick sale (see the next section) or a pre-negotiated plan, but they cannot be eliminated.

The Toys "R" Us case encapsulates the risks presented to retailers in chapter 11. In that case, the debtors were able to procure over $3 billion in post-petition financing prior to their filing, seemingly providing a soft landing into bankruptcy. Nonetheless, what followed was a terrible holiday season—as competitors courted customers and customers stayed away—leading to unsustainable cash burn and the wind down of the U.S. business. Ultimately, vendors in the U.S. received only partial payment on their post-bankruptcy claims, and secured lenders saw their collateral depleted. While other retail debtors faced similar challenges in 2019, some debtors achieved different outcomes either through quick asset sales (e.g., the sale by Nine West of its intellectual property) or by proposing a prepackaged plan (e.g., Mattress Firm). In early 2019, one debtor (ShopKo) obtained financing for an expedited chapter 11 process under which, if a going-concern transaction is not consummated within 90-days, the debtor will "toggle" to a liquidation and sale.

Over the past several years, prepackaged filings have appealed to retailers looking to minimize their time in Chapter 11 and to maintain consumer confidence, which can be easier to do in a shorter proceeding. Less time in court mean less cost to the process. These businesses often reach agreements on a plan knowing from day one which stores to close and which to sell in the marketplace. DIP funding is locked up with the pre-petition lenders who have assessed the risks of higher losses if the business simply does a "going out of business sale."

In 2018 and 2019, major debtors all took advantage of § 363 of the Bankruptcy Code. Section 363 is a powerful provision under which the debtor, upon court approval, may sell property "free and clear" of liens and liabilities. Section 363 is an especially valuable tool for companies, including many retailers that simply cannot bear the risk of a "free fall" chapter 11.

## THE STALKING HORSE BIDDER

In the context of a § 363 sale, it is common for debtors to reach an agreement with a "stalking-horse bidder" before or soon after the bankruptcy filing, ensuring stability during the sale process and setting a floor for other bids. Both strategic and financial investors are often presented with the question of whether to act as a stalking horse. Doing so has advantages: more time for due diligence; setting the baseline terms for the purchase agreement; the opportunity to build relationships with the company; and the ability to procure court-approved bid protections, such as a break-up fee and expense reimbursement.

But there are also disadvantages: the stalking-horse bidder, even after reaching an agreement with the company and post-petition financing sources, faces the risk of being "re-traded" by a creditors' committee or other objectors, including on substantive points such as deal milestones and bid protections. These objections can often be addressed through negotiation or (if necessary) by the court. But there has also been a troubling trend in recent cases whereby objecting creditors, in an effort to secure a marginally lower break-up fee or a slower schedule (among other things), have sought intrusive discovery of stalking-horse bidders, requiring the stalking-horse bidder to manage and finance an expedited litigation before the auction even starts. In this environment, potential stalking-horse bidders must be prepared to deal with the multiple stakeholders in a chapter 11 process, including committees, and to hold firm against overreaching demands that increase cost or defy commercial expectations.

## THE GOOD

Outside of retail chapter 11s, prepackaged filings frequently share key features. Many are operationally sound but are operating under unmanageable debt loads (or, in the case of asbestos, vap and opioid manufacturer debtors, under the specter of unliquidated tort liabilities). They are generally not looking to benefit from the automatic stay or non-

consensual third-party releases, nor are they interested in rightsizing their real estate footprints or rejecting significant contractual obligations.

Instead, these debtors are looking to consummate quick, consensual restructurings with minimal disruption to their business operations. To effectuate these prepackaged cases, debtors often pay general unsecured claims in full or have them "ride through" bankruptcy and receive payment in the ordinary course. Similarly, employees are generally unaffected under prepackaged plans. In leaving these parties unimpaired, debtors avoid the need to solicit them (see Bankruptcy Code § 1126(f)), thus streamlining their bankruptcy processes and saving time and money.

It is often argued that prepackaged cases promote stability as well as resulting in reduced overall costs versus conventional Chapter 11 cases. Although companies incur significant pre-petition legal and advisory fees as they negotiate with their lenders and other key constituencies, draft and negotiate key documents and pleadings, and solicit votes on their plans, their short time in Chapter 11 often results in limited legal and advisory fees on behalf of official committees. In particularly fast-moving cases, debtors may avoid the appointment of a committee of unsecured creditors altogether if general unsecured claims are paid in full or have them "ride through" bankruptcy and receive payment in the ordinary course.

Moreover, by limiting their time in bankruptcy, debtors in prepackaged cases minimize the statutory fees due and owing to the United States Trustee (see 28 U.S.C. § 1930(a)(6)). Prepackaged filings may enable debtors to operate through the consensual use of cash collateral, without the need to secure debtor-in-possession financing, with its attendant fees and expenses. Lastly, the significantly reduced execution risk and time in Chapter 11 reduce the normal and often unavoidable "creep" of costs and expenses attendant to longer proceedings.

## THE BAD

By disclosing their intention to file for bankruptcy, debtors run the risk of their creditors and interest holders taking steps to protect themselves, to the detriment of the debtors and their other creditors. For example, note holders or lenders may cease funding the debtors' operations or limit debtors' availability under existing facilities, demand that debtors provide excess collateral, commence litigation to credit, execute on extant judgments, orchestrate involuntary bankruptcy proceedings, or exercise other available remedies against assets or against guarantors. Similarly, aggressive trade creditors may opt to shorten or eliminate payment terms, stop providing goods or services entirely, or take other available steps to protect themselves under the UCC.

Without the protection of the automatic stay, creditors may be unwilling to negotiate and are fully empowered to resort to state law and other remedies. Creditors may also take the opportunity to exert leverage in negotiations and may seek to fix the amount of their claims or resolve non monetary disputes, as debtors are often incentivized to negotiate to secure votes and/or eliminate potential objections to their prepackaged plans.

**Hinds & Shankman, LLC** is available to assist you with any inquiries regarding bankruptcy issues.

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