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Out-of-court Workouts, Prepacks and Pre-arranged Cases: A Primer

Contributing Editors:
Prof. John D. Ayer
University of California at Davis; Chico, Calif.
jdayer@ucdavis.edu

Michael L. Bernstein
Arnold & Porter LLP; Washington, D.C.
michael_bernstein@aporter.com

Jonathan Friedland
Kirkland & Ellis LLP; Chicago
jonathan_friedland@chicago.kirkland.com

Editors' Note: *In most chapter 11 cases, the debtor first files bankruptcy and then negotiates a plan. But in a significant number of cases, the plan is negotiated before the bankruptcy filing. Occasionally, the plan is negotiated, circulated to creditors, and voted on before the case is filed. And then there are situations where the restructuring can be accomplished without a bankruptcy filing. This month, we discuss these exceptions to the "file now, negotiate later" approach.*

When you start to learn about chapter 11, they tell you how the debtor calls its creditors together and cuts—or fails to cut—a deal.

The alert student will say: "That's *all*? If that is all there is to it, why do they need bankruptcy? Indeed, why do they need a court? Why not—well, why not just cut the deal?"

Very good questions. And the answer is: "Very often, they do." Debtors have always cut deals with creditors. A fair number of us make a decent living by orchestrating these out-of-court workouts. Indeed, the better measure of success as a restructuring lawyer is the number of cases we keep *out* of bankruptcy, not the number we take in.

There are some obvious advantages to an out-of-court workout. It is likely to be quicker and cheaper than a chapter 11 case. You may be able to sidestep a lot of paperwork and avoid a lot of unwanted attention.

But there are also some clear disadvantages. If there are more than a handful of creditors, just trying to orchestrate all the parties can prove to be an insurmountable hurdle. Moreover, even if you get agreement from a lot of creditors, there is no way to keep dissenters in line. Dissenters and holdouts may see an opportunity to achieve a disproportionate recovery. They can derail the whole operation by demanding a precipitous levy. Or they can simply refuse to accept the deal.

There are, as we have discussed in prior installments, a number of protections you can achieve in chapter 11 that may not be available outside. You can, for example, hold creditors at bay through the automatic stay. You can impose the plan on dissenters through Bankruptcy Code §§1126 and 1129. You can use the rejection powers of Code §365 to get rid of burdensome contracts. And you can avoid and recover prior payments under chapter 5. Moreover, there may be tax advantages to doing your deal in bankruptcy. For example, the cancellation of debt in a chapter 11 case is ordinarily not included in gross income (although it does reduce tax attributes). *See* IRC §108. If you do the same deal outside of bankruptcy, you may have a big tax bill. If you need these protections, then chapter 11 is the card you are likely to play.

If, however, the only thing about your company that is broken is its balance sheet, then the mere *threat* of chapter 11 can be enough to trigger out-of-court settlement. This helps to explain the decline in chapter 11 filings over the past few years. The Code is now more than a quarter of a century old. Parties—in particular, creditors—are a good deal more sophisticated now than they were then, are better able to understand the potential cost of chapter 11 and are more willing to accept a settlement rather than to fall into the briar patch.

Of course, creditors may sometimes prefer chapter 11, even with the added expense. If you don't trust the debtor, you may be happy to have some judicial supervision. And in bankruptcy, you don't have to worry quite as much about another creditor cutting a faster and better deal than you, since the Code assures equality of distribution to similarly situated creditors.

Prepacks

A prepackaged bankruptcy (or "prepack") is a form of consensual chapter 11 restructuring that significantly reorders the traditional reorganization process. "Prepackaging" a chapter 11 reorganization enables a debtor to minimize the impact to its ongoing business operations by combining many of the best aspects of out-of-court workouts—cost-efficiency, speed, flexibility and cooperation—with the binding effect and structure of a conventional bankruptcy.

Unlike a traditional chapter 11 case, the prepackaged bankruptcy is negotiated and accepted by creditors *before* a proceeding is commenced in the bankruptcy court. In theory, therefore, the prepackaged bankruptcy itself can be quick (sometimes as fast as 30-45 days), and therefore less costly and damaging to the restructuring company. It is particularly useful for those businesses that are very sensitive to public image, such as retailers. If they are in bankruptcy for a long time, the public may become skeptical and their image may be tarnished, sometimes beyond repair. If they can get in and out quickly and without a lot of public fighting, they have a better chance to emerge unscathed.

In a prepackaged case, the debtor negotiates and drafts a reorganization plan. It then circulates the plan-accompanying disclosure statement and ballot to creditors. The creditors have a period of time to review the disclosure statement and vote on the plan. If the debtor receives sufficient votes to confirm the plan, it then files a bankruptcy petition, the plan, the disclosure statement and the ballots all at the same time. If it works, most of the action is done before the company is in bankruptcy. In bankruptcy, the debtor just needs retroactive approval of the disclosure statement and confirmation of the plan.

The Code recognizes the prepackaged case. Take a look at §1126(b). This section allows the court to count votes on a plan that were solicited before the case was filed, so long as the acceptance does not violate other laws and so long as the voting creditors had the advantage of the same sort of information they would have received before voting in chapter 11.

In a large "public company" case, the negotiations often revolve around the bondholders. For the bondholder, an imaginative observer might ask: "Why not simply put a provision into the original bond agreement, providing that a plan accepted out of court will be binding on dissenters?"

The answer to that question is that the law doesn't allow it. "Public" bond issues are governed by the Trust Indenture Act of 1939 (11 U.S.C. §77aaa). The Trust Indenture Act specifically provides (§316(b)) that the rights of a bondholder shall not be impaired without his consent. The provision is nonwaivable (§327). This rule, coupled with the practical inability to get all bondholders to the proverbial table (or to even know who they are) probably explains the bulk of the public-company prepack action.

So why doesn't everyone use a prepack if it is quicker and cheaper than a normal chapter 11 case? First, you need to have the kind of case where you can make a deal with a large majority of creditors before bankruptcy. That depends in large part on the nature of your creditor constituency. If the creditor group is relatively small and the debt is fairly concentrated, maybe you can get together, make a deal and then "run it through bankruptcy." Even if you can't make a deal with everyone, you can get agreement from the required majority and bind dissenters. But if you have hundreds of bondholders and trade creditors with little concentration of the debt, you're not likely to be able to use the prepack.

There are some risks to a prepack. You do the solicitation based on a disclosure statement that has not been blessed by the court in advance. A dissenter may come in after the fact and challenge the adequacy of the disclosure and/or the method of soliciting votes. If the court sustains the challenge, you have to "do it over again." This can be expensive, cause delay and sometimes delay the whole process.

Partial Prepacks

There are some cases where you can solicit certain classes of creditors before filing chapter 11 and other classes afterward. These are referred to as partial prepacks. There are several reasons you might do this. Let's say you have a case with a large bank, a relatively small group of bondholders and a thousand trade creditors, each of which is owed $1,000 or so. You can probably make a deal with a majority in number and two-thirds in debt amount of the bank class and bondholder class, but it is not practical with the dispersed group of small trade creditors. So maybe you solicit the bank and bonds before bankruptcy and then file and solicit the trade in chapter 11, after obtaining approval of the disclosure statement. It may even be that you have a better chance of quick acceptance from the trade if you can tell them that you already have a deal with the bank and the bonds (which presumably has something in it for the trade).

Sometimes there are also securities law-driven reasons for this approach. If the consideration being given to creditors under the plan are securities, then ordinarily the debtor must prepare and file with the Securities and Exchange Commission (SEC) a registration statement. This is a time-consuming and expensive process. Bankruptcy Code §1145 provides an exemption for securities that are distributed under a reorganization plan in exchange for claims or interests (or principally in exchange for claims and interests and partially in exchange for cash or other property). But the exemption does not appear to apply to pre-petition solicitations. To deal with this problem, the debtor will sometimes do pre-petition solicitation of those classes where the §1145 exemption is not necessary (such as those classes that are not getting securities under the plan) and post-petition solicitation for those classes where the exemption is needed.

Pre-arranged or Pre-negotiated Cases

The terms "pre-arranged bankruptcy" or "pre-negotiated bankruptcy" do not have specific definitions. In a most general sense, they refer to any chapter 11 case in which the debtor has discussed with *some* constituency prior to the commencement of bankruptcy *some* form of corporate reorganization or restructuring to be accomplished through the chapter 11 process and has received *some* form of commitment (which may or may not be contractual or binding by its terms) from the constituency to support a chapter 11 plan that accomplishes that reorganization or restructuring.

Generally, however, a pre-arranged or pre-negotiated bankruptcy refers to a reorganization or restructuring that is, prior to the commencement of bankruptcy, (1) negotiated with representatives of the most significant constituencies that are expected to be impaired and whose acceptance is sought or needed for confirmation (*i.e.,* the senior lenders, bondholders and principal equity security-holders), (2) agreed to by those representatives (even if those representatives, by themselves, are not sufficient in number or amount to assure acceptance of the particular classes of debt that they represent), and (3) memorialized in written agreements containing the basic terms of a reorganization plan.

The most significant procedural difference between a pre-arranged plan and a prepackaged plan is that solicitation occurs after the bankruptcy case has been filed and after the court has approved a disclosure statement.

Sometimes, in lieu of a vote (as one would get in a pre-pack) the debtor tries to get an agreement by the creditors to support a plan that contains certain basic terms, which is sometimes referred to as a "lock-up agreement." This is common in cases involving an outside investor who may want to know that the creditors will support its transaction before devoting the necessary resources. While most lock-up agreements are entered into before bankruptcy, post-petition lockups have been criticized by courts, particularly in Delaware, as violating the solicitation rules of Code §1125. If you are thinking of entering into a post-petition lockup agreement, have a look first at Judge Walrath's decisions in *NII Holdings Inc.,* Case No. 02-11505, and *NII Holdings Inc.,* Case No. 02-11505 (MFW).[1] ■

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1 If you shoot Jonathan Friedland an e-mail asking for these cases, he'll gladly forward them to you.