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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

The Pros And Cons Of Prepackaged Bankruptcy

Law360, New York (October 02, 2013, 4:58 PM ET) -- A prepackaged bankruptcy is a bankruptcy case that begins with the filing of a plan of reorganization that has already been accepted by creditors (or as to which solicitation of acceptances is already underway as of the date of the initiation of the bankruptcy case). The bankruptcy case is the means of implementing the accepted plan.

Generally, there are three other methods of restructuring a company against which to compare and contrast a prepackaged bankruptcy.

(1) An out-of-court restructuring is a restructuring that does not require the debtor to file for bankruptcy. Out-of-court restructurings can include a credit facility amendment, an exchange offer or a consensual restructuring of any other kind of liability, though the usual out-of-court restructuring deals with funded debt, as opposed to trade or tort liabilities.

Unless the underlying documents permit otherwise, each out-of-court restructuring requires the creditors to consent to the treatment that they receive. Absent such consent, a creditor cannot be compelled to accept treatment that is inconsistent with its contractual rights.

(2) A prenegotiated bankruptcy case, which is similar to a prepackaged bankruptcy, is a restructuring in which the company and key creditors agree upon the terms of a restructuring and contractually bind themselves to such terms through a lockup agreement without yet having engaged in the voting process mandated by Section 1126 of the Bankruptcy Code.

After the lockup agreement is executed, the company initiates a Chapter 11 case to implement the restructuring. (Unlike a prenegotiated bankruptcy, in a prepackaged bankruptcy, solicitation is actually initiated or completed before the bankruptcy case is commenced.)

The company will seek the approval of the bankruptcy court of a disclosure statement, solicit votes on the plan and seek an order from the bankruptcy court confirming the plan. The key difference between an out-of-court restructuring on the one hand and a prepackaged or prenegotiated bankruptcy on the other hand is that the latter allows the company to impose a treatment of claims on dissenting creditors so long as the company satisfies the confirmation standards of the Bankruptcy Code.

(3) A conventional bankruptcy case is one in which the debtor files for Chapter 11 relief without having agreed in advance to the terms of a plan of reorganization with its creditors. During the course of the Chapter 11 case, the debtor or, if the debtor does not retain the exclusive right to propose a plan, a creditor or creditor group may formulate and propose a plan of reorganization.

Advantages to a Prepackaged or Prenegotiated Bankruptcy

For parties-in-interest, a prepackaged or prenegotiated bankruptcy has several key advantages:

- Outside of bankruptcy, indentures and credit agreements typically require unanimous written agreement of noteholders or lenders to implement a transaction that affects the fundamental economics of a deal (e.g., changes to the coupon, maturity, principal and other economic terms). Because all holders must approve these changes, holdouts or nonresponsive parties can frustrate the process. Through the Chapter 11 plan process, the Bankruptcy Code allows for a class of creditors to make binding changes to all aspects of an indenture or credit agreement if the affected class of creditors accepts the proposed treatment by two-thirds in dollar value and one-half in number of creditors voting. Accordingly, through a prepackaged or prenegotiated bankruptcy, a debtor, working in concert with a critical mass of its creditors, can implement changes without being hindered by holdouts or nonresponsive parties.

- For a debtor, the filing of a Chapter 11 case may be disruptive to key constituencies, such as customers, suppliers and employees. By formulating and obtaining binding support in favor of a plan before a Chapter 11 case is initiated through a prepackaged or prenegotiated bankruptcy, the debtor's business faces significantly less uncertainty and disruption as a result of the bankruptcy case. When the filing is made, the debtor has the opportunity to broadcast a strong positive message to its constituencies, which can indicate that the debtor will be more competitive in the business because it is anticipated that it will have a more manageable capital structure in the immediate future.

- Chapter 11 debtors often must seek bankruptcy court approval and consequently, input from creditors for nonordinary course business decisions, which can include, for example, the employment of professionals, the formulation of a budget and nonordinary course asset sales. Such transactions may require disclosure, negotiation with creditors, motion practice and potentially, litigation. In a prepackaged bankruptcy, because the debtor's time in Chapter 11 is minimized and the debtor has a clear path out of bankruptcy, far fewer business decisions require court approval.

- By implementing a restructuring through a Chapter 11 case, a debtor and other participants in the process may be able to obtain court-approved releases (mutual releases and, in certain limited circumstances, third-party releases), exculpations and court findings of good faith. These protective provisions can be a significant benefit to the parties to the negotiation. Like all aspects of a plan, these provisions must conform to the applicable legal standards of the Bankruptcy Code.

- A debtor who seeks to solicit votes for a plan during a Chapter 11 case is required to formulate and obtain bankruptcy court approval of a disclosure statement, which meets the standards of Section 1125 of the Bankruptcy Code. Although a Section 1125 disclosure statement is not required for a prepackaged bankruptcy solicitation (because the solicitation is done outside of bankruptcy), a debtor must nonetheless comply with applicable securities laws. In practice, the debtor will often draft a disclosure statement that meets the standards of Section 1125 of the Bankruptcy Code although the debtor is not technically obligated to do so. Nonetheless, however, the debtor has a degree of freedom with respect to the disclosure statement in a prepackaged bankruptcy case that the debtor does not have in a conventional bankruptcy case.

Important Considerations for a Prepackaged or Prenegotiated Bankruptcy

For a company considering a prepackaged or prenegotiated bankruptcy, there are three important considerations:

(1) For most companies facing an impending Chapter 11 case, including a prepackaged or prenegotiated bankruptcy case, lenders of capital either: (a) are not likely to lend to the company; or (b) will require security for the loan because, upon the filing of the Chapter 11 case, the loan will become a prepetition claim.

Because an out-of-court, prepackaged and prenegotiated process takes at least several weeks, if not several months, to effectuate, one of the critical questions for the company and its advisors to consider (and one of the potential pitfalls of a prepackaged or prenegotiated bankruptcy) is whether the company either has sufficient liquidity for the duration of the pre-filing period or is able to obtain additional financing.

(2) Upon the filing of a Chapter 11 petition, an automatic stay arises pursuant to Section 362 of the Bankruptcy Code, which prevents creditors from enforcing remedies against the debtor and its assets. No specific order of a court is required to obtain the stay. The automatic stay, which is broad, generally stays:

- the commencement or continuation of all proceedings against a debtor that could have been or were commenced prior to the commencement of the case;
- all efforts to enforce a pre-filing judgment against the debtor; and
- any act to obtain possession of property of the debtor or perfect a lien against debtor property.

There are significant exceptions to the stay, such as the exercise of a government's police powers, the continuation of criminal proceedings and the unwinding of certain financial transactions. Most importantly, the automatic stay generally applies only to the debtor and not the debtor's nondebtor affiliates, officers and directors.

Nonetheless, however, in certain limited circumstances, pursuant to Section 105 of the Bankruptcy Code, courts have extended the application of the automatic stay to such entities. As such, the automatic stay is a powerful protection for the debtor, which forces creditors into a single, organized proceeding, allowing the debtor to concentrate its efforts on a coordinated and holistic restructuring.

In a prepackaged or prenegotiated bankruptcy, during the pre-filing period, which is when the company formulates, negotiates and documents the proposed plan, the company does not have the protection afforded by the automatic stay, which means that creditors can enforce remedies against the company and its assets at any time.

For example, prior to the initiation of a bankruptcy case, a creditor can seek to obtain a judgment on a claim against the company and attach assets or, in concert with other creditors, file an involuntary bankruptcy proceeding against the company.

To mitigate the possibility of these issues, the company will need to communicate regularly with its creditor constituencies, maintain its credibility during this period and monitor potential situations that could upset the pre-filing status quo. If possible, the company should obtain a waiver, forbearance or standstill agreement from key creditors for this period of time to mitigate the chance of creditors taking action against the company or its assets so that the company can remain focused on the plan process.

At the outset of the discussions that the company will have with its key creditors about the process, the company should indicate its willingness to participate in a consensual and constructive process; however, the company will need to note that if the company and the key creditors are committed to exploring a restructuring, for an appropriate period of time under the circumstances, the focus of discussions, attention and resources should be dedicated to the potential restructuring and not to concerns about creditors taking a precipitous act.

An appropriate waiver, forbearance or standstill agreement will remove such concerns for the company, indicate all parties' good-faith commitment to a process, and, with a larger creditor group, prevent one creditor that is part of the process from acting in a manner contrary to the interests of all parties.

If the key creditors are part of a credit facility with an agent, the agent may be able to enter into such an agreement without all parties to the credit facility executing the waiver, forbearance or standstill agreement depending on the terms of the underlying credit facility, which should be reviewed carefully.

(3) Generally, prepackaged plans are not a feasible approach if the company will not be either reinstating or paying in full pre-petition trade, lease rejection, employee or union claims. These groups of creditors typically are difficult to identify outside of Chapter 11.

In a conventional or prenegotiated bankruptcy case, such creditors are generally represented by a committee of unsecured creditors owing fiduciary duties to all unsecured creditors, appointed by the United States Trustee. Specifically, if unsecured claims such as these are not reinstated or paid in full, the United States Trustee will appoint a statutory committee of unsecured creditors.

The appointment process typically takes at least two weeks from the petition date. The committee has standing to be heard on all issues in the Chapter 11 case and will require time to form, hire professionals, review the debtor's plan and formulate a response.

Although a prepackaged plan may not be feasible if the company will not be either reinstating or paying in full pre-petition trade, lease rejection, employee or union claims, the company and its key creditors can consider utilizing the prenegotiated approach, with a timeline that allows for formation of a statutory committee and a reasonable period of time to engage with its professionals.

The amount of time required will vary greatly depending on the circumstances. Generally, such a timeline would not be less than two months and more likely would be about four to six months. If the proposed plan involves issues that raise concerns for the committee, such as investigations into pre-petition transactions or avoidance actions, depending on the complexity of the circumstances, more time may be required.

--By Morris J. Massel, Simpson Thacher & Bartlett LLP

Morris Massel is counsel in the bankruptcy department of Simpson Thacher & Bartlett in the firm's New York office.

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