How to Restructure Debt Outside Chapter 11

In Chapter 11 the only choice for a company that can't pay its debts? What about just striking a deal with creditors? How do the costs, speed and risks compare with Chapter 11? When does a non-bankruptcy approach have the best chance of success? How can the company deal with creditors who are not willing to cooperate? Will the company be leaving money on the table by not utilizing Chapter 11? If the company needs to liquidate, is bankruptcy the only way?

Your company is in financial distress. A financial restructuring, or perhaps even liquidation, appears inevitable. Your first thought might be that the company has no choice but to file under Chapter11. But Chapter 11 is strong medicine-in the bad sense as well as the good. The expense, duration and risk associated with Chapter 11 mean that it should be considered a last resort. What non-bankruptcy alternatives might be available?

If the company's goal is to continue in business, particularly under current ownership, then a creditor composition or a lender workout should be considered. If new ownership is an acceptable outcome so long as the business is preserved as a going concern, then additional non-bankruptcy alternatives would include a cooperative secured party sale, receivership or even an assignment for benefit of creditors. If the company must liquidate, then an assignment for benefit of creditors or a trust mortgage should be considered. These approaches are reviewed in sequence below, followed by discussion of the advantages and disadvantages of each in comparison with Chapter 11 or Chapter 7 bankruptcy.

Non-Bankruptcy Alternatives

Creditor Composition. A creditor composition is an agreement between a debtor and its creditors, and among the creditors. The basic deal is for the company to make one or more payments to creditors, and for creditors to forbear from legal action so long as the company makes the scheduled payment(s) and complies with any other agreed-upon obligations or restrictions. If the composition provides less than payment in full, creditors agree to discharge the unpaid balance. The company may initiate the composition process by simply distributing a proposal to its creditors, negotiating with key creditors, or by inviting creditors to a meeting for the purpose of organizing a committee to represent the interests of all similarly-situated creditors – much as would the official creditors' committee in a Chapter 11 case.

The terms of any particular creditor composition can be quite varied, depending on the underlying business and financial situation. For example, a creditor composition might contemplate the sale or orderly liquidation of the company and payment of proceeds to creditors, the continued operation of the company with the debtor making periodic payments creditors, or settlement of creditors' claims for a lump sum, perhaps supplied by investors or refinancing. The composition agreement can establish operating and/or financial benchmarks for the troubled company, as well as, place restrictions on certain activities such as transactions with affiliates, executive compensation, and asset dispositions.

A composition will be binding only on creditors who elect to be bound. Hold-outs are a problem from the perspective not only of the company (aggressive collection activity by non-assenting creditors could force the company to file under Chapter 11) but also the assenting creditors, who typically are willing to make concessions only if other similarly-situated creditors do so too. For this reason, most composition agreements are drafted so as only to take effect if assented to by a very high percentage of creditors – often, 90 percent. Some composition agreements provide that if this threshold is not met, but the company does obtain sufficient assents to confirm the composition as a Chapter 11 plan, then the company may utilize the composition agreement as the basis for a prepackaged Chapter 11 case. To learn more about prepackaged Chapter 11 cases, in some instances, a trust mortgage (discussed below) can serve to protect against hold-outs, as well as, provide security for assenting creditors.

Lender Workout. Because it may be difficult to obtain the near-unanimity required for a successful out-of-court composition and to surmount operating problems that could arise if the company acknowledged its inability to pay its suppliers, a more realistic approach will sometimes be for the company to seek concessions solely from financial creditors such as the company's bank group, equipment lessors and bondholders. An agreement to restructure the debt of a particular creditor, particularly a bank group, is sometimes called a "workout agreement." In a workout agreement, lenders may agree to defer interest or principal payments, to extend the time of repayment, to reduce the principal amount of indebtedness, or a combination thereof. A workout agreement might call for asset dispositions, granting of additional collateral, operation benchmarks, financial reporting requirements, and other items. As part of the workout, the lenders might even agree to advance new funds.

Why would a bank group agree to significant concessions while trade creditors make none? If the bank group is unsecured, then obtaining a lien on the company's assets might be a significant incentive. If the banks are already secured, then their usual perspective is that trade creditors should be making not just reciprocal, but disproportionate concessions in recognition of the banks' right to be paid first in a liquidation. This is one reason that secured lenders often steer the debtor toward Chapter 11, because in bankruptcy their absolute priority over unsecured creditors will be recognized. The lenders may even offer attractive debtor-in-possession financing as an inducement. However, in some instances Chapter 11 would be fatal for the business and liquidation would provide lenders with such an unsatisfactory return that a workout - or perhaps sale of their claims at a substantial discount – may be accepted by the lenders as the best available approach.

Secured Party Sale. A "secured party sale" entails the secured creditor's exercise of its right to foreclose its collateral by way of public or private sale in accordance with the Uniform Commercial Code and other applicable law. This is a common method of liquidating a failed business. Yet a secured party sale may also serve as a vehicle to quickly and inexpensively implement a financial restructuring under which the company's business is sold as a going concern, free and clear of the company's liabilities.

In what respect is this type of transaction a restructuring rather than a liquidation? If managers and employees retain their jobs, and perhaps even receive stock options or other performance incentives from the new entity, then from their perspective the transaction looks nothing like a liquidation. If the foreclosing lender owns or provides financing for the new entity, then from the lender's perspective the transaction is also a restructuring. In rare instances the company's stockholders may participate by receiving equity in the new entity – although this can magnify legal risk even if the stockholders invest new funds and receive an ownership percentage proportional to the investment. For a discussion of legal issues that must be considered by the new entity.

Receivership. A receiver is a court-appointed fiduciary who takes possession of a company's assets (occasionally, a specified sub-set of the assets) in order to protect the rights and interests of creditors. Receivership almost invariably means the assets will be sold, although the receiver may have latitude to operate the business and sell it as a going concern rather than shutting it down and conducting a liquidation sale. Standards for appointing receivers vary from jurisdiction to jurisdiction, and in some instances are set by statute. Generally, only a secured or judgment creditor may seek appointment of a receiver. A receiver may be available whenever requested by a secured party to aid in liquidation of collateral, or only upon showing that the petitioning creditor will suffer significant harm in the absence of a receiver, such as by the threat of the debtor's concealment or impairment of assets. In some instances, the petitioning creditor may select the receiver, in others; receivers (whose quality may vary markedly) are appointed by the court.

Although receivership is a creditors' remedy, the debtor company might through negotiation assents to the receivership in exchange for achieving some of its goals. For example, the company and secured creditor might agree on who will serve as receiver, how the sale process will be conducted, and whether the secured creditor will give up a portion of the net proceeds to provide a distribution for unsecured creditors. The company may have significant leverage in these discussions because of management's ability to assist the receiver in maximizing value and, conversely, the company's ability to file a bankruptcy petition that would supersede or at least delay the receivership.

Assignment for Benefit of Creditors. An assignment for the benefit of creditors provides a means for liquidating a troubled company's assets, rather than restructuring its debts so that the company may remain in business. The assignment is effected by written agreement whereby the debtor assigns all of its assets to an assignee (an independent fiduciary for creditors), who undertakes to conduct an orderly liquidation of the assets and distribute the proceeds to creditors. The assignee's fees and expenses are paid first, with remaining liquidation proceeds distributed in accordance with any applicable state law or (in the absence of a state law requirement) in conformity with the priorities established by the Bankruptcy Code. Any surplus would be returned to the debtor company. Creditors are invited to file a proof of claim and assent form with the assignee in order to receive their distribution, if any.

Assigned property remains subject to all preexisting liens, providing secured creditors the option of either pursuing their own remedies or permitting the assignee to dispose of their collateral and remit net proceeds to the secured creditors. Generally, creditors will not be able to attach the assigned property. A disgruntled creditor's remedy would be to participate in filing an involuntary bankruptcy petition against the debtor/assignor. When a bankruptcy petition is filed, the bankruptcy court may choose to defer to the assignment if it appears to have broad creditor support; if the petition follows a proper assignment by 120 days or more, the court must defer to the assignment.

As assignment for the benefit of creditors can be a simpler, speedier and less expensive means of liquidating a company's assets than a Chapter 7 bankruptcy. It can be less onerous to a company's management, because there are no schedules to complete or other duties required of officers in a Chapter 7 liquidation. Creditors often welcome an assignment in lieu of a bankruptcy because the distribution (if any) to creditors will likely be more prompt. Creditors who have received payments that a bankruptcy trustee might challenge as preferential transfers have an additional reason to favor an assignment; conversely, where there are significant preferential or fraudulent transfers that might be recoverable by a bankruptcy trustee, or where there is otherwise significant creditor distrust of management and/or reason to have a trustee investigate the debtor's affairs, creditors may shun a proposed assignment in favor of an involuntary petition against the debtor.

Trust Mortgage. Whereas an assignment for the benefit of creditors is the non-bankruptcy analog to a Chapter 7 liquidation, a trust mortgage may serve the same function as a Chapter 11 case. A trust mortgage may provide the framework for a management-conducted liquidation or may be used to provide security for the company's obligation to creditors under a composition agreement, as discussed above. Rather than make an absolute conveyance of its assets to a fiduciary for the creditors, the troubled company grants a security interest. This lien secures the company's performance of specified obligations to its creditors, which might include payments to creditors, benchmarks for financial performance or asset sales, financial reporting, and restrictions on certain activities. If the debtor fulfills its obligations under the trust mortgage, then the trustee will terminate his lien without the trustee ever having resorted to his remedies as a secured party. If the debtor fails to meet its obligations, then the trustee has the right to foreclose his security interest and liquidate the company's assets for the benefit of creditors, much in the manner of an assignment for the benefit of creditors.

In the context of a financial restructuring where the debtor company will continue in business, a trust mortgage provides a vehicle for the company to provide assurance that it will meet its restructured obligations to creditors. It also provides a means of dealing with "hold-outs" – creditors who refuse to go along with the restructuring – since the trust mortgage can provide that only creditors assenting to the trust mortgage will become beneficiaries entitled to receive payments and the benefit of the lien held by the trustee. Of course, as in the case of an assignment for the benefit or creditors, dissenting creditors may file an involuntary bankruptcy petition. But the company might be able to persuade the bankruptcy court to dismiss the petition if the trust mortgage has broad creditor support.

In the context of liquidations, a trust mortgage may be appropriate where a company's management would be more effective at conducting the liquidations than would be a creditors' fiduciary. For example, management might believe that the best way to maximize value for creditors would be to sell the company as a going concern, which might entail keeping key managers and employees in place, and perhaps continuing to operate during the sale process. Or perhaps self-liquidation would be most effective simply because company managers can quickly find the most likely buyers and obtain the best sale prices. An obstacle to this approach may be creditors' skepticism or even antipathy. Creditors may conclude that even under the watchful eye of a creditors' trustee, the managers who presided over the company's failure cannot be trusted to maximize its value in liquidation.

Advantages/Disadvantages of Non-Bankruptcy Alternatives

Expense. The length of a Chapter 11 case is the chief driver of cost. A lengthy Chapter 11 reorganization tends to be considerably more expensive than non-bankruptcy alternatives. In Chapter 11 or out of court, the debtor will usually be required to pay the costs not only of its own professionals, but those of the general unsecured creditors' committee and, in many cases, secured creditors. Of course, in weighing the alternative approaches, cost is only half the equation; the other half is benefit. Viewing the cost of each possible approach as an investment, managers should generally elect the approach that provides the best return on the investment.

Speed. A non-bankruptcy alternative will generally be quicker than a Chapter 11 case, although a prepackaged or pre-negotiated Chapter 11 plan may shorten the case to two or three months. In any event, negotiations toward a prepackaged Chapter 11 plan, creditor composition or lender workout will inevitably take time. Therefore, these approaches will only be available if the company is able to function outside Chapter 11 for the period necessary to complete negotiations with creditors.

Business Operations. While negotiations leading to an out-of-court restructuring are underway, suppliers may become nervous and demand COD payment. The company may need to "freeze" old liabilities and pay only for current goods and services. For the company's management, dealing with conflicting demands for a lengthy period will certainly be stressful, and may not be feasible. Most managers report that filing Chapter 11 actually reduces operating stress because the rules are clear (no pre-bankruptcy liabilities may be paid without court approval) and the automatic stay under bankruptcy law bars collection activity by creditors.

Disclosure. In Chapter 11, the debtor is required to file with the bankruptcy court a schedule of assets and liabilities, along with a financial questionnaire. The debtor most also file detailed financial reports with the United States Trustee. These documents are accessible to the public, including competitors. For a private company, the level of disclosure is far beyond what management is used to. Public availability of information can be avoided in a non-bankruptcy restructuring. However, the creditors' committee in either a Chapter 11 case or a non-bankruptcy restructuring will typically, through its financial advisor, require access on a confidential basis to detailed information about the company, its financial history and its ongoing operations.

Contracts and Leases. Debtors in Chapter 11 have the power to reject burdensome contracts and, in the case of some contracts (real estate leases, for example) to limit the non-debtor's claim for damages. Chapter 11 debtors also have the power to assume advantageous agreements that outside bankruptcy might be terminated by the non-debtor party due to the debtor's breach. Finally, in Chapter 11 the debtor may assign an assumed contract, at a profit, despite any contractual prohibition. If the exercise of these powers would add material value from the standpoint of creditors or the company, Chapter 11 may be the best route to implement the debt restructuring.

Limitation on claims. Chapter 11 imposes limits on certain types of claims. For example, Chapter 11 caps the landlord's claim for breach of a lease at one year's rent or, if greater, 15 percent of the remaining rent under the lease.

Avoidance Actions. Chapter 11 debtors have the power to avoid preferential and fraudulent transfers. The existence of material avoidable transfers for example, where the debtor has recently granted a lien to its banks would argue for utilization of Chapter 11.

Hold-outs. Chapter 11 may be necessary to avoid problems created by non-assenting creditors. While non-assenting creditors cannot usually be bound to an out-of-court restructuring, they can be bound by the terms of a confirmed Chapter 11 plan. Accordingly, where the viability of a restructuring is at risk due to non-assenting creditors, Chapter 11 may be the only realistic choice. The perceived inevitability of hold-outs in the non-bankruptcy scenario is one of the major reasons that companies file under Chapter 11.

Debt Relief. In theory, creditors should not require a premium for striking a deal outside Chapter 11, except perhaps to reflect the lesser professional fees in an out-of-court restructuring. In reality, debtors are seldom able to achieve out of court the magnitude of debt relief that would result from a Chapter 11 filing. Moreover, creditors will seldom assent to an out-of-court arrangement providing a small percentage distribution even when the debtor's financial circumstances preclude a larger payment. However, where the debtor can afford a relatively high percentage pay-out (even if over an extended period) and can avoid being pressured into a bankruptcy filing during the period of negotiation with creditors, non-bankruptcy alternatives to Chapter 11 may off a favorable trade-off of cost, risk and result. Back to resource center