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# Southwest Bankruptcy Conference

*Business*

## **Pre-Bankruptcy Planning: Too Much or Too Little?**

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## Pre-Bankruptcy Planning: Too Much or Too Little?



## The Panel

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## Introduction

Chapter 11 counsel must evaluate several issues as part of pre-bankruptcy strategic planning.

How much pre-bankruptcy planning is too much? How much is too little?

Where is the line between setting up a successful case and risking bad faith dismissal, appointment of a trustee or conversion?

Can too much pre-bankruptcy planning put the debtor under grey cloud with the Court and creditors rendering any reorganization more challenging and expensive?



## Developing an Exit Strategy

- Unlike fine wine, bankruptcy cases typically do not get better with age.
- Business considerations.
- A Chapter 11 reorganization?
- Does the Debtor need exit financing?
- New Value contribution?
- Chapter 11 sale and then dismissal/conversion (aka Chapter 3)?



## Timing of Petition

- Timing is uniquely within the control of debtor
- Debtor's counsel should consider all of the following:
  - *Rent due date – know how your jurisdiction treats stub rent*
  - *Payday*
  - *Creditor rights/impending remedies*



## Venue Options

Venue for Bankruptcy Cases is governed by 28 U.S.C. § 1408 which provides:

(1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, [...]; or

(2) in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership.

What venue options are available? Different circuits? If so, analysis of variations in circuit level authority for any key issues may be required.

What are the strategic and tactical considerations?



## Entity Formation, Acquisition or Resurrection for Venue Purposes

*Winn-Dixie Stores, Inc.:*

24 related entities filed bankruptcy in Southern District, New York.

Basis for venue in Southern District, New York was a New York entity, Dixie Stores, Inc., which was formed a mere 12 days prior to filing bankruptcy by lead debtor's counsel.

Bankruptcy Court granted motion to transfer venue to Florida.



## Retaining Outside Fiduciaries

As part of pre-bankruptcy planning, Debtor may want to retain an independent director; chief restructuring officer; or financial advisor .

- Address potential insider actions and transactions
- Remedy prior mismanagement
- Blunt motion to appoint Chapter 11 trustee

Counsel should ensure that Debtor's organizational documents allow for an independent director/CRO.

Does the independent director or manager need separate counsel?



## Negotiating Use of Cash Collateral

- 11 U.S.C. §363(c)(2)
- First ask, is it "cash collateral"?
- Consent v. adequate protection
  - *Valuation is key*
  - *What if there is no equity cushion?*
  - *Protection ≠ improvement*
- Budgeting





## Negotiating DIP Financing

- Is cash collateral insufficient?
- Is unsecured or junior secured financing unavailable?
- Economic terms
  - *Role of financial advisor*
- Other Terms
  - *E.g. milestones, defaults, roll-ups, carve-outs, avoidance actions, waivers, etc.*
- Timing Considerations



## Pre-Bankruptcy Uptiering

- Transaction:
  - *Debtor obtains new senior financing while concurrently exchanging a portion of existing secured debt for 1.5 lien debt, with remaining existing secured debt surviving with 2<sup>nd</sup> lien priority and few, if any, covenants (see, e.g., Serta)*
- Debtor Perspective:
  - *Increases liquidity and runway*
  - *Creates friendly class of creditors*
- Senior Creditor Perspective:
  - *Elevates priority and, thereby, recovery*
  - *Ensures control*



## Payments to Critical Vendors and Other Creditors

- Considering that commercial claims will generally be treated as general unsecured claims in a Chapter 11, what really needs to be paid pre-petition? What needs to be paid immediately post-petition?
- What are the ethical limitations in advising whether or not to pay claims?
  - *Rule 1.2(d) of the Model Rules of Professional Conduct: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."*
- Cal. Civil Code § 3432: *"A debtor may pay one creditor in preference to another, or may give to one creditor security for the payment of his demand in preference to another."*



## Identify (Create?) Friendly Creditors

Impaired Accepting Class: 11 U.S.C. § 1129(a)(10)

- Debtors routinely choose who to pay and not pay in advance of petition date
- Can the Debtor "engineer" an impaired accepting class?
- In re Bataa/Kierland LLC, 476 B.R. 558 (2012)
  - Holding: vote of "friendly" secured creditor created shortly before Chapter 11 filing was not solicited or procured in bad faith under § 1126(e)
  - "Bad faith is found in the effort 'to secure some untoward advantage over other creditor for some ulterior motive.'" *Id.* at 565 (citing *In re Figter Ltd*, 118 F.3d 635 (9<sup>th</sup> Cir. 1997)).





## Can You File Under Subchapter V?

11 U.S.C. §§ 1181 et seq.

- Subchapter V offers numerous advantages vs. “big” Chapter 11
  - *No disclosure statement*
  - *No creditors’ committee*
  - *Easier solicitation of votes*
  - *No absolute priority rule*
  - *No need for impaired accepting class – 11 U.S.C. 1191(b)*
- *Qualifying for Subchapter V*
  - *Noncontingent and liquidated debts of not more than \$7,500,000*



## Public Relations

Communications with employees, vendors, shareholders, etc.

- Debtor has the first opportunity to shape the conversation
- Be aware of restrictions on communications under bankruptcy and non-bankruptcy law
  - *11 U.S.C. § 1125*
  - *Securities Exchange Act and Blue Sky Laws*
    - Prohibits selective or misleading public communications about a covered entity
- When in doubt, consult with outside corporate counsel



## Restructuring Support Agreement (aka Plan Support Agreement)

- Pre-negotiated vs. pre-pack
- 11 U.S.C. § 1129(g): solicitation loophole
- Terms:
  - Commits creditor(s) to support a plan
  - Commits Debtor to certain treatment of creditor class(es)
  - Creditors will not support competing plans
  - Specified timeline for filing of plan
- Increase certainty, minimize chance
- Minimize time spent in Chapter 11



## Change Tax Status

Prior to filing bankruptcy, can a debtor's principals change the Debtor's tax status from passthrough to non-passthrough to shift any tax liabilities to the bankruptcy estate upon filing of the bankruptcy petition.

If this occurs, is it basis for bad faith dismissal or appointment of a trustee?

If this occurs, can estate reverse the pre-petition tax election?

When/how is the change even disclosed to or discovered by creditors.



## Divisive Merger

Statutorily created right in several jurisdictions, including Texas, Delaware and Arizona.

Form of corporate mitosis.

Infamous example, Texas Two step- LTL Management, LLC

LTL Management created as part of a divisive merger and had certain assets and liabilities assigned to it.

2 days later LTL Management files for bankruptcy

Case dismissed for bad faith filing.

“That said, we mean not to discourage lawyers from being inventive and management from experimenting with novel solutions. Creative crafting in the law can at times accrue to the benefit of all, or nearly all, stakeholders. Thus we need not lay down a rule that no nontraditional debtor could ever satisfy the Code’s good-faith requirement while LTL faces substantial future talc liability, its funding backstop plainly mitigates any financial distress foreseen on its petition date.” *In re LTL Management, LLC*, 64 F.4th 84, 110-111 (3rd Cir. 2023).

# Faculty

**Andrew A. Harnisch** is a shareholder with May, Potenza, Baran & Gillespie P.C. in Phoenix, where he focuses his practice in bankruptcy, insolvency and corporate reorganization, as well as commercial litigation and receivership. He has a broad range of experience representing debtors, creditors and trustees in a variety of state and federal court proceedings. Mr. Harnisch was recognized as a *Southwest Super Lawyers* “Rising Star” in 2015 and 2016 and in *Southwest Super Lawyers* from 2021-23. He also served as a director of the Bankruptcy Section of the Maricopa County Bar Association from 2011-13. In 2010, Mr. Harnisch was recognized as one of the Top 50 *Pro Bono* Attorneys in Arizona by the Arizona Foundation for Legal Services & Education. He received his B.A. in 2003 from the University of Arizona and his J.D. in 2006 from the University of Southern California Gould School of Law.

**Steven D. Jerome** is a partner in the Phoenix office of Snell & Wilmer L.L.P., where his practice primarily focuses on assisting clients (both debtors and creditors) with solving problems pertaining to insolvency and potential insolvency situations. His services include assessing businesses’ solvency and potential restructuring options from a legal and economic perspective, evaluating the assets reachable by creditors and competing creditors’ claims to available assets, reviewing and enforcing creditors’ rights, and protecting clients’ rights in state or federal courts. In addition, he is experienced in providing bankruptcy advice on transactional matters, including nonconsolidation, true sale, perfection and preference bankruptcy opinion. Mr. Jerome served as chair of the State Bar of Arizona’s Bankruptcy Section from 2006-07, has been a master of the Arizona Bankruptcy American Inn of Court since 2013, and is a member of ABI and the American Bar Association. He was listed in *The Best Lawyers in America* for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law, Bankruptcy Litigation from 2013-23, and in *Southwest Super Lawyers* for Bankruptcy & Creditor/Debtor Rights from 2010-22. Previously, Mr. Jerome clerked for Hon. Timothy J. Mahoney with the U.S. Bankruptcy Court for the District of Nebraska. He is admitted to practice in the Supreme Court of Arizona, the U.S. District Courts for the Districts of Arizona and Colorado, and the U.S. Courts of Appeals for the Third, Ninth and Tenth Circuits. Mr. Jerome received his B.S. in 1994 from Santa Clara University’s Leavey School of Business and his J.D. *cum laude* in 1997 from Creighton University School of Law.

**Samuel R. Maizel** is a partner in Dentons US LLP in Los Angeles and leads the firm’s health care industry restructuring efforts nationwide. His practice includes bankruptcy matters as well as financial restructurings, both in and out of court. Mr. Maizel has served as lead counsel to debtors, trustees, buyers of assets, state attorneys generals and creditors’ committees, and as a trustee, examiner, patient care ombudsman and consumer privacy ombudsman in chapter 7, 9 and 11 cases. His most recent debtor representations include Curitec, a durable medical equipment supplier that filed in Houston; Borrego Community Health Foundation, a chain of 19 federally qualified health care centers that filed in San Diego; Agsprings, a family of grain industry companies that filed in Wilmington, Del.; Astria Health, a chain of nonprofit hospitals that filed in Yakima, Wash.; and Verity Health System of California, a chain of six hospitals and the second-largest nonprofit hospital bankruptcy case in U.S. history that filed in Los Angeles. Mr. Maizel has lectured extensively, is widely published, and has been interviewed on television and radio. He is the only lawyer in the U.S. ranked in both health

care and bankruptcy by *Chambers and Partners* and *The Best Lawyers in America*. A Fellow of the American College of Bankruptcy, he was named a “Legal Visionary by the *Los Angeles Times* in 2023; recognized as one of its “Top 100 Lawyers for 2022” by the *Los Angeles Business Journal*; awarded the “Outstanding Lawyer Award” for distinguished service as outside counsel to nonprofit organizations by the American Bar Association in 2022; and named by the *Daily Journal* as one of California’s “Top Healthcare Lawyers” in 2021. In addition, Global M&A Network named him “Restructuring Lawyer of the Year” in 2020. He also has been named in *Super Lawyers* every year since 2007. Mr. Maizel received his B.S. in 1977 from the U.S. Military Academy at West Point, his M.A. from Georgetown University in government in 1983 and his J.D. in 1985 from George Washington University School of Law, where he won the Jacob Burns Prize for excellence in appellate advocacy and served as president of the Moot Court Board.

**Jennifer M. Taylor** is a partner in the San Francisco office of O’Melveny & Myers LLP in its finance and restructuring groups. She represents debtors and creditors in connection with workout transactions and chapter 11 reorganizations. She also regularly represents investors in connection with distressed acquisitions of businesses and debt. Ms. Taylor has deep experience negotiating debt-financing transactions of all varieties, including financings for leveraged buyouts, secured and unsecured working capital facilities, venture debt facilities and other structured financings, including mezzanine loans, high yield and DIP financing for debtors in bankruptcy. She has been ranked by *Chambers USA*, recognized as one of the 500 Leading Bankruptcy & Restructuring Lawyers by *Lawdragon*, named one of the Top Women in Dealmaking by *The Deal* magazine, and was honored in 2019 as one of ABI’s “40 Under 40.” She received her B.A. in political science and economics from Stanford University and her J.D. *cum laude* from the University of California, Hastings College of the Law, where she was a member of the *Hastings Law Journal*, as well as a recipient of the ABI Medal of Excellence, the Witkin Award for Academic Excellence in Bankruptcy, and the CALI Awards in Legal Writing and Research, Bankruptcy and Secured Transactions.