

Prepack Bankruptcy Strategies and Problems

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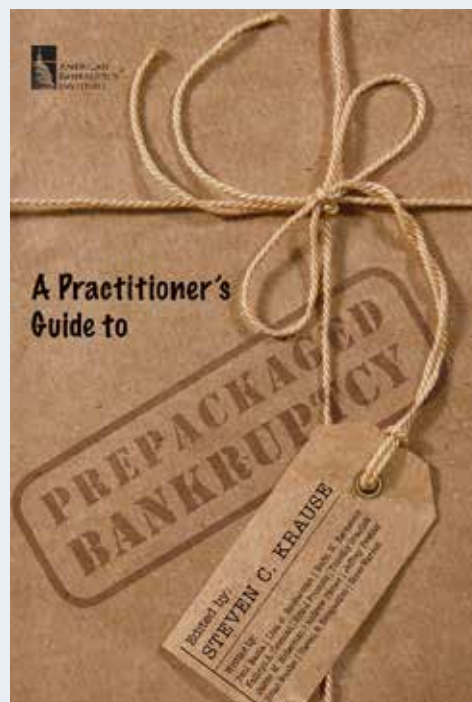
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A Practitioner's Guide to Pre-packaged Bankruptcy: A Primer

While a conventional bankruptcy filing is frequently a viable option for a company seeking to reform its capital structure and operations, it is certainly not the only alternative. Recent years have seen a significant rise in prepackaged bankruptcy filings. This primer serves as a guide to prepackaged bankruptcy and assists practitioners in the evaluation of restructuring alternatives, comparing the advantages and disadvantages of prepacks to the advantages and disadvantages of out-of-court restructurings or conventional filings. The book delves into the foundation for prepacks established in the Bankruptcy Code and in local bankruptcy rules and guidelines, as well as the historical basis for prepacks. It also summarizes the prepack process and contrasts this process with the process for conventional filing. Finally, the primer examines several significant prepacks and identifies a number of recent ones.



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GLOSSARY OF TERMS

Pre-Packaged Bankruptcy (a/k/a Prepack)

A Prepackaged Bankruptcy ("Prepack") is a chapter 11 proceeding where the plan and solicitation process is commenced before the petition is filed. Requirements for the contents of the plan and confirmation are the same as a traditional "free fall" bankruptcy but the process of disclosure and solicitation are different. Typically a Prepack will leave a class of unsecured claims unimpaired.

Prenegotiated Plan

A Prenegotiated Plan of Reorganization is one in which the debtor negotiates the terms of its plan with major creditors but no formal solicitation is commenced until after the petition is filed. Agreements with major creditors are generally memorialized via plan support or "lock up" agreements. Prenegotiated Plans allow greater flexibility for rejection of leases, assignments of executory contracts and impairment of unsecured creditors.

Plan Support Agreements (a/k/a Lock-Up Agreements)

Agreements used in pre-negotiated chapter 11s whereby key creditors agree to support a plan of reorganization provided it contains certain terms. PSA's are often assumed as part of the plan of reorganization.

Applicable Non-Bankruptcy Law

Bankruptcy Code Section 1126(b) and Bankruptcy Rule 3018(b) require that solicitation of creditors whose interests are adversely impacted must comply with "applicable non-bankruptcy law." In a traditional chapter 11, this issue is disposed of at the hearing on the adequacy of the disclosure statement usually by reference to Section 1125. In a Prepack, it must be considered without court assistance. The most common issues arise with respect to federal and state securities laws.

GLOSSARY OF TERMS

Reasonable Time

Bankruptcy Rule 3018(b) requires that solicitation materials be provided so that there is a reasonable time to act with respect to acceptance or rejection of a plan. There is no definition of what constitutes a reasonable time.

Bankruptcy Rule 2002(b) provides for not less than 28 days. The Southern District of New York's Prepack guidelines set limits of 14-21 days depending on the nature of the claims, differentiating between claims arising from publicly traded securities and other types of claims.

Note that none of these deadlines, other than 2002(b), are hard and fast but it appears that 14-28 days is the likely range.

Creditors Entitled to Vote

Bankruptcy Rule 3018(b) provides that the real party in interest is entitled to vote a claim or interest and that mere record title holders do not have a vote. Accordingly, the debtor must be prepared to demonstrate that the beneficial holders of claims and interests were solicited and have voted.

ADVANTAGES AND DISADVANTAGES

ADVANTAGES TO PREPACKAGED BANKRUPTCY



ADVANTAGES: Time

- Because Prepackaged plans are negotiated between the debtor and its creditors before chapter 11 filing, they generally reduce time. This allows a debtor to commence its reorganized operations as soon as possible.
- The prepack chapter 11 proceeding generally takes between 30-45 days. This allows a debtor to exit chapter 11 and commence its reorganized operations as soon as possible.
- On the other hand, in a typical bankruptcy case, it is not unusual for the debtor to spend at least two years in the chapter 11 process, and a prearranged bankruptcy can be completed in 100-150 days.

ADVANTAGES: Costs

- Because prepackaged bankruptcy proceedings are usually of such limited duration, the postpetition costs of the actual chapter 11 case are much less than those incurred in a traditional chapter 11 case.
- As a result of the expedited schedule, fees and costs associated with monthly reports, U.S. Trustee fees, attorneys and other professionals are minimized.

ADVANTAGES: Certainty

- Prepackaged bankruptcies reduce uncertainty because creditors already know what to expect from the reorganization, and there are no risks of competing reorganization plans.
- The debtor has the exclusive right to file a plan during this period.

ADVANTAGES: Minimize Damage to Public Image

- When the filing is made, the debtor has the opportunity to broadcast a positive message to its constituencies, which can demonstrate the debtor will be more competitive because it is projected that it will have a more manageable capital structure in the near future.

ADVANTAGES: Unanimous Consent Not Required

- A prepackaged plan of reorganization requires acceptance of only 50% in number of claims of each class voting and 2/3 in amount of each impaired class of creditors to bind all dissenters.
- In a workout, dissenters are not bound, and the controlling documents often provide that unanimous consent is needed to restructure debt.

ADVANTAGES: Control

- The debtor has more control over the process in prepackaged cases than in regular chapter 11 cases.
- If voting creditors vote to reject the plan, the debtor can simply negotiate another plan prior to filing its bankruptcy petition.
- In a regular case, creditors may seek to convert the case to chapter 7, terminate the debtor's exclusive period to file a plan, and force a sale or other disposition of the case the debtor does not want.

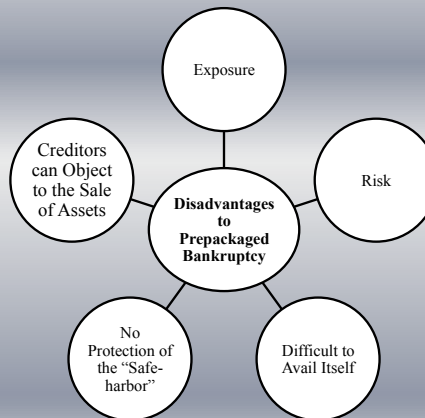
ADVANTAGES: Obtaining Protective Provisions

- Parties involved in negotiating a prepackaged plan may enjoy the benefits of significant court-approved release and exculpation protections, shielding their good faith efforts from possible legal challenges brought by nonconsenting holdouts and encouraging creditor participation in the restructuring process.
- These protective provisions can be a significant benefit to the parties to the negotiation.

ADVANTAGES: Tax Benefits

- Avoids cancellation of indebtedness income and, in certain circumstances, preserves the ability to use pre-restructuring net operating losses.
- For example, with an informal workout, if debt with a face value of \$1000 is exchanged for debt with a value of \$500, the reduction of \$500 is considered to be income for tax purposes. However, if this exchange is executed through a formal bankruptcy filing, it does not lead to an income tax liability.

DISADVANTAGES TO PREPACKAGED BANKRUPTCY



DISADVANTAGES: Exposure

- Prepackaged plan negotiations expose the debtor to the risk of creditor action because they put creditors on notice of intent to file a chapter 11 petition before the protections of the automatic stay are obtained.
- 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 allows creditors to enforce remedies against the company and its assets at any time.

DISADVANTAGES: Risk

- There is a substantial risk that at the confirmation stage, the Court may determine that the proposed disclosure statement or process of solicitation are inadequate.
- Further, if a debtor has hundreds of small trade creditors, it may be harmful to negotiate with them pre-bankruptcy because they might stop doing business with the debtor or try to enforce their legal rights.
- Gives Creditors leverage.

DISADVANTAGES: Difficult to Avail Itself

- Debtor may find it difficult to avail itself of downsizing through the use of executory contract rejection under Section 365 or sale of assets under 363 of the Code because the time period after filing is relatively brief.

DISADVANTAGES: No Protection of the “Safe-Harbor”

- A proponent of a prepackaged plan may not have the protection of the “safe-harbor” provided to those who solicit votes based on a disclosure statement approved pursuant to Section 1125 of the Code.
 - Section 1125(e) provides a safe harbor for good faith solicitations of votes on a chapter 11 plan which protects debtors against liability for state and federal securities laws.

DISADVANTAGES: Creditors Can Object to the Sale of Assets

- Even if all impaired classes of creditors vote to accept a company's prepackaged plan, a creditor can still object to the prepackaged plan based on:
 - Adequacy of the pre-petition disclosure
 - Inadequate notice and solicitation
 - Plan confirmation, which includes objections to the proposed sale

COMPARING PROCEDURES

CLASSIC REORGANIZATION	PREPACKAGED	PRENEGOTIATED
<ul style="list-style-type: none"> • Debtor files a bankruptcy petition • Eventually negotiates a plan of reorganization with its creditors • Seeks court approval of a disclosure statement • Then solicits votes in favor of the plan • Assuming sufficient votes are obtained, debtor seeks confirmation of the plan, often litigating confirmation issues to cram down a dissenting class of creditors 	<ul style="list-style-type: none"> • Debtor negotiates its bankruptcy plan • Arranges dip financing, if necessary • Solicits votes on the plan • Files disclosure statement, plan, the results of its petition solicitation, and a motion seeking both approval of the disclosure statement and confirmation of the plan • Files its bankruptcy petition • Courts will consider the disclosure statement and confirm the plan in a single hearing near the end of the case 	<ul style="list-style-type: none"> • Debtor negotiates its bankruptcy plan • Debtor and creditors agree upon terms of a restructuring and contractually bind themselves through a lockup agreement • After lockup agreement is executed, debtor initiates a chapter11 case to implement restructuring • Debtor seeks the approval of the bankruptcy court of a disclosure statement, solicits votes on the plan and seeks an order from the bankruptcy court confirming the plan