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# Prepackaged and Prenegotiated Chapter 11 Reorganizations Evaluating the Benefits and Risks of Pre-Bankruptcy Restructuring Plans

## A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

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**Thursday, June 25, 2009**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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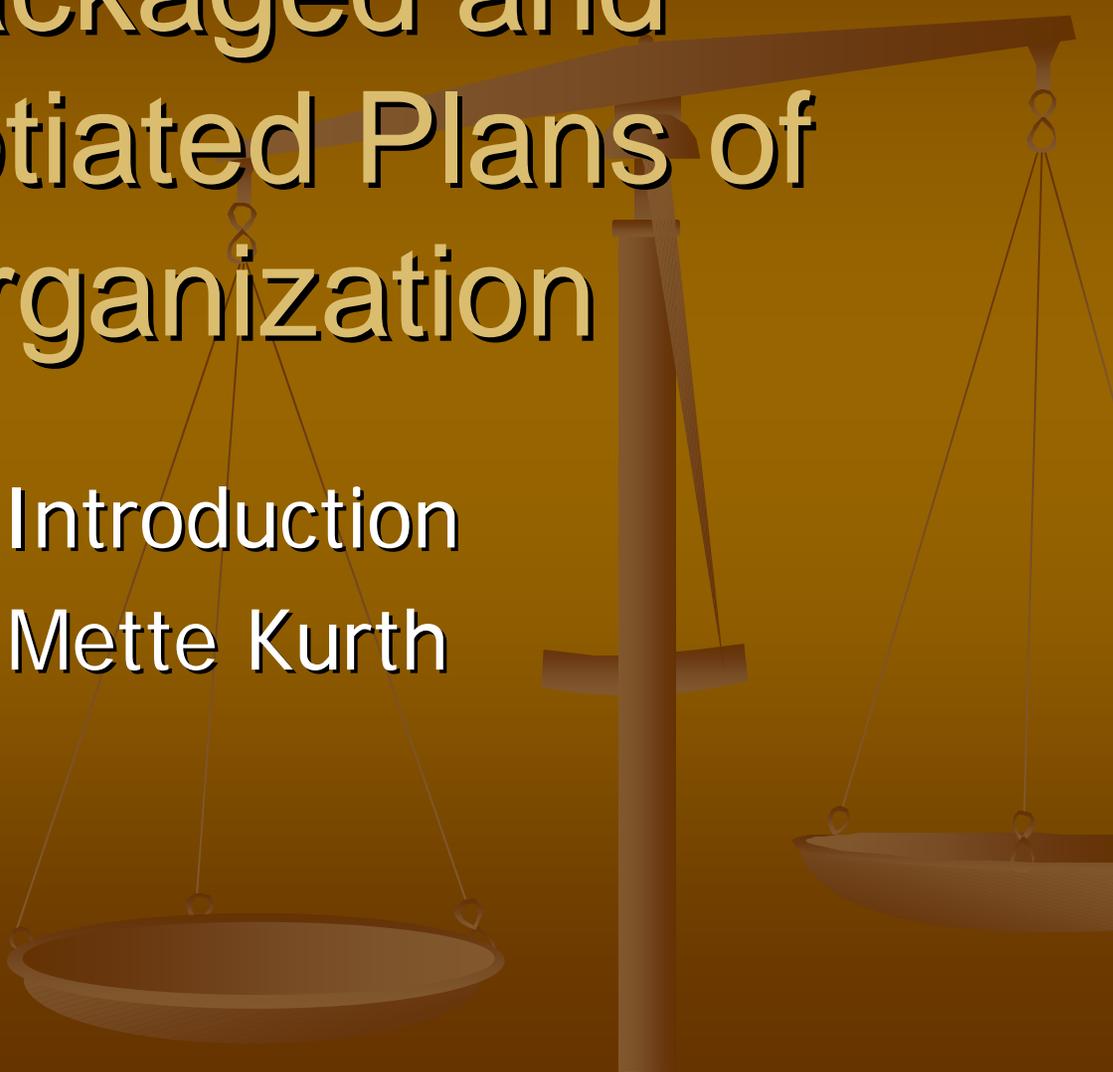
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# Prepackaged and Prenegotiated Plans of Reorganization



An Introduction  
By Mette Kurth

# Typical Chapter 11 Bankruptcy Case

- Debtor:
- 1. negotiates a plan of reorganization with its creditors
- 2. files a plan and disclosure statement
- 3. obtains approval of the disclosure statement by the court after notice and a hearing
- 4. transmits the plan and disclosure statement to its creditors and equity security holders for consideration and voting
- 5. counts the votes on the plan and submits those results to the bankruptcy court
- 6. attends a confirmation hearing where the bankruptcy court considers the plan and the votes thereon, and determines whether the plan should be confirmed.

# Timing Issues In Chapter 11 Case

- Chapter 11 gives the debtor a period of exclusivity in which only it can file a plan for the first 120 days of the case (1121(b)).
- If the debtor files its plan within that 120 period, no other plan may be filed during the first 180 days of the case while the debtor tries to obtain creditor acceptance of its plan (Section 1121(c)(3)).
- The bankruptcy court has the power to extend or reduce the 120 day and 180 day periods (1121(d)).
- If the debtor fails to file a plan and obtain creditor acceptances within the specified time periods, any party in interest may file a plan and more than one plan may be filed.

# “Prepackaged” Chapter 11 Plan

- In a Prepackaged plan of reorganization:
    1. The negotiation with the creditors,
    2. Disclosure statement preparation and dissemination,
    3. Solicitation of the creditor’s votes, and
    4. Creditor acceptance of the plan
- all occur before the bankruptcy petition is filed.

# Timing Issues in Prepackaged Chapter 11 Cases

- The Southern District of New York's Procedural Guidelines for Prepackaged Chapter 11 Cases state that:
  1. At least two days prior to the anticipated filing date of the prepackaged Chapter 11 case, the Debtor should notify the US Trustee of the Debtor's intention to file such a case.
  2. Also two days prior to filing, the Debtor should discuss the filing with the Clerk of the Court.

Furthermore:

1. When the bankruptcy petition is filed in a prepackaged case, the debtor will also file the plan and request a hearing date to consider confirmation of the proposed plan that will require at least twenty-five days notice (Bankruptcy Rule 2002(b)).
2. The bankruptcy court may under certain circumstances approve the agreement on an expedited basis for cause (Bankruptcy Rule 4001(c)).

# Timing Issues in Prepackaged Chapter 11 Cases Continued

- Pursuant to Fed.R. Bankr.P 2018(b), the Court will consider whether “an unreasonably short” time was prescribed for creditors and equity security holders to accept or reject the plan.
- Depending on the plan, the Court will generally approve as reasonable a ten or twenty business day voting period.
- However, the court is allowed to permit a shorter voting period if it is justified in a particular case or a longer period if a party in interest can demonstrate that the voting period was not reasonable in a particular case.

# Difference between Prepackaged and Nonprepackaged Bankruptcies

- The primary difference is that a prepackaged bankruptcy is filed after the negotiation and filing have taken place, while a nonprepackaged bankruptcy is filed before the negotiation and voting have taken place.

# Benefits of Prepackaged Plan over Traditional Chapter 11 case

- Speed and Cost:

Because the prepackaged bankruptcy is negotiated and accepted **before** a proceeding is commenced in the bankruptcy court, a prepackaged bankruptcy can be much quicker, and possibly less expensive, than a traditional Chapter 11 case.

# Risks of Prepackaged Plan

- The debtor needs retroactive approval of the disclosure statement and the confirmation of the plan by the court.
- If a dissenter comes after the submission of the plan to the court and challenges the adequacy of the disclosure, and the court sustains the challenge, the soliciting process may have to be repeated, causing delay and increasing costs.

# Benefits of Prepackaged Ch. 11 Case Over Out of Court Settlement

- With a prepackaged plan, one can:
  1. After achieving confirmation of the plan of reorganization, bind all of one's creditors regardless of whether such entities have accepted or rejected the plan
  2. Impose the plan on dissenters and hold-outs
  3. Hold creditors at bay through automatic stay
  4. Use the rejection powers of Code Section 365 to get rid of burdensome contracts
- Tax advantages of Prepackaged plan:
  - a. Cancellation of debt in Ch. 11 case not considered gross income
  - b. Can preserve the firm's net operating loss carryforwards

# Disadvantages of Prepackaged Plan Over Out of Court Settlement

- An operating company may impair or damage its relationships with trade creditors, suppliers and customers when it begins soliciting entities to vote on the prepackaged plan.
- Creditors have the right to seek the appointment of a trustee to displace the debtor's management, or to seek the appointment of an examiner to investigate the debtor's management and report the findings to the court (Section 1104 of Bankruptcy Code).

# Prenegotiated Plan of Reorganization

- Prenegotiated bankruptcy refers to a reorganization that is, prior to the commencement of bankruptcy:
  1. Negotiated with representatives of the most significant creditors whose acceptance is sought or needed for confirmation;
  2. Agreed to by those representatives; and
  3. Memorialized in written agreements containing the basic terms of the reorganization plan.

# Timing Issues with Prenegotiated Bankruptcies

- The deadlines facing a prenegotiated bankruptcy are the same as those in a standard Chapter 11 case.
- However, as a practical matter, because consensus with major creditors has usually already been reached prior to filing bankruptcy, the prenegotiated bankruptcy is usually confirmed more quickly than a standard Chapter 11 case.

# Distinctions Between Prepackaged Plans and Prenegotiated Plans

## Prepackaged Plan

- Disclosure is made and creditors vote on the plan according to set procedures prior to bankruptcy filing.
- Compliance is required with certain statutory requirements and procedures mandated by the Bankruptcy Code, Bankruptcy Rules and certain federal and states securities laws.

## Prenegotiated Plan

- The debtor negotiates pre-bankruptcy with its major creditors.
- The debtor makes no pre-bankruptcy solicitation; solicitation occurs after the bankruptcy case has been filed and the court has approved the disclosure statement.
- The creditors do not vote on the plan pre-bankruptcy.

# Situations in which Prepackaged Plans are Most Effective

- Prepackaged plans are most effective where one can make a deal with a large majority of creditors before bankruptcy.
- This is most likely if the creditor group is relatively small and the debt is fairly concentrated.
- Even if one can't make a deal with everyone, if one can get  $\frac{2}{3}$  of the voting creditors from each class in amount and more than  $\frac{1}{2}$  of voting creditors in number to agree to the plan, one can bind dissenters and avoid a hold-out problem.

# Situations in which Prenegotiated Plans are Most Effective

- If a debtor does not wish to deal with the nonbankruptcy rules which may govern a prepackaged plan, a pre-negotiated plan may be the better option for the debtor.
- This is especially true if the creditors are “knocking at the door” and the debtor does not have sufficient time to thoroughly negotiate each point of a prepackaged plan and solicit acceptances thereto.
- In such cases, the debtor can simply reach the principal terms of a deal with its major creditors, and work out the rest in bankruptcy, under the protection of the automatic stay.

# Venue Issues in the Bankruptcy Context

- A company can only file for bankruptcy in the following places:
  1. The location of the principal place of business, or
  2. The place of incorporation or formation of the company, or
  3. Where an affiliate or subsidiary has already filed for bankruptcy (Section 1408).
- Where multiple venues may satisfy the statutory requirements, the party-in-interest (or the court on its own initiative) can claim that an alternative venue is more appropriate and may seek to have the venue transferred to any other bankruptcy court that satisfies the venue requirements. The bankruptcy court is authorized to transfer venue of a case to another district “in the interests of justice or for the convenience of the parties” (Section 1412).

# Prepackaged Bankruptcy in Major Markets: Cases and Failure Rate by Court and by Prepackaged Status<sup>1</sup>

	Delaware	New York	Other Courts	Total
<b>Nonprepackaged</b>	46%	81%	82%	72%
<b>Prepackaged</b>	54%	19%	18%	28%
<b>N</b>	26	16	56	98

Pearson chi-square = 12.264, p = .002

Court	Prepackaged			Nonprepackaged		
	Refilings	Plan Failures	Cases	Refilings	Plan Failures	Cases
<b>Delaware</b>	7 50%	9 64%	14	4 33%	5 42%	12
<b>New York</b>	0 0%	1 33%	3	3 23%	4 31%	13
<b>Other Courts</b>	0 0%	2 20%	10	2 4%	6 13%	46
<b>Total</b>	7 26%	12 44%	27 100%	9 13%	15 21%	71 100%

Cell entries are numbers and percentages of cases in each court that failed  
(p-values relate to differences between courts within columns).

p = .009

p = .095

p = .011

p = .062

1. . Lynn M. Potucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 Vand. L. Rev. 1933, 1975 (2002).

# Bankruptcy in major markets

- Delaware: Bankruptcy judges are very experienced in dealing with prepackaged bankruptcies. More than half of all prepackaged bankruptcies are filed in Delaware.
- One drawback might be that Delaware does not have any specific local rules governing prepackaged bankruptcy.
- Prepackaged bankruptcies in Delaware have the highest rate of failure in the nation, with 64% of such plans failing.

# Bankruptcy in Major Markets

## Cont'd

- New York: The US Bankruptcy Court for the Southern District of New York has bankruptcy judges with substantial experience in handling mega-cases of national importance.
- In addition, it has specific local rules governing procedures for prepackaged bankruptcies.
- Still, 33% of prepackaged plans filed in New York fail, a far lower percentage than in Delaware, but still higher than the 20% average rate of failure that prepackaged bankruptcies have in all states other than Delaware and New York.

# The Creditor's Perspective

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June 25, 2009

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# Creditor Constituencies

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- Creditor perspectives
  - Supporting Creditors
    - Creditors willing to support prepackaged/prenegotiated plan to be proposed by company
  - Opposing Creditors
    - Holdouts seeking better/different recoveries
  - Impaired Creditors
    - Creditors who will vote on the plan
  - Unimpaired Creditors
    - Creditors who are deemed to accept the plan and therefore do not vote

## Prepack Benefits to Supporting Creditors

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- More efficient process for highly consensual deal
  - Full blown bankruptcy is very expensive and time consuming
  - Prepack in court part of process can be done in weeks to months and avoid significant costs
- Execution risk reduced
  - Particularly with highly consensual deals
- Cooperative effort with company
  - Cannot underemphasize the benefit of a company that proactively works with its creditors to solve the problem

## Prepack Benefits to Supporting Creditors

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- Ability to bind dissenters
  - Biggest limitation to out-of-court reorganizations is the inability to bind meaningful holdout creditors
  - 66.6% in amount and 50% in number is magical
  - Makes "holdout game" very expensive by requiring a blocking position in 33.3% of the debt being compromised
  - Often see prepackaged solicitation coupled with an exchange offer for similar economic terms as coercive mechanism to promote out-of-court transaction

## Prepack Benefits to Supporting Creditors

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- Releases
  - Prepack can provide broad releases to supporting creditors against claims by holdouts
- Confirmation Protections
  - Court confirmation blesses transaction and mitigates risks of out-of-court deal regarding:
    - Fraudulent Transfer
    - Preference
    - Lender Liability
- Ability to Reinstate Debt that might not exist in out-of-court deal

## Limitations on Utility

- Required High Consent Threshold
  - Can be difficult to achieve, particularly in publicly traded debt
  - Transparency of true holders – privacy of holdings
- Works Best for Balance Sheet Restructuring of Financial Debt
  - Not a good instrument for trade, litigation and other claims in the context of a large company
  - Not efficient for fraud based restructurings
  - Difficult to adequately identify and solicit claims other than financial debt
- Not Ideal for Business Restructuring

## Limitations on Utility

- Substantial Lead Time to Solicit
  - The pre-bankruptcy process of a prepack is much longer than the actual time in bankruptcy
  - No automatic stay, so company must have resources or forbearance from creditors
- Lack of 1145 Exemption
  - Prepetition process may not have 1145 protection
  - Can limit ability to solicit non-QIBs (i.e. retail investors)
- Stability of Liquidity – process can be lengthy and company must have resources to fund operations throughout

## Limitations on Utility

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- Lack of Transparency/Control over Company
  - Out-of-court there is no oversight of company behavior comparable to that applicable in bankruptcy
  - Company must comply with applicable disclosure rules (bankruptcy and securities laws)
  - No 363 protections, so company can enter into non-ordinary course transactions
- Limitations on New Money Economics
  - Bankruptcy law may make some out-of-court economics not viable

## Limitations on Utility

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- May trigger regulatory scrutiny/liability that would not apply to an out-of-court deal: e.g., environmental, pension
- Creates a forum for disaffected creditors to cause mischief
  - Potential broad rights to discovery
  - Technical bankruptcy law fights to harass company and threaten deal
  - Potential new statutorily created players (creditors committee / equity committee)
- Impact on business – some businesses just can't have the B-word (bankruptcy) associated with them
- Intellectual Property Risks

## Prepack Process

- Company recognizes need for reorganization
  - On its own or through investor urging
- Identify & organize creditors
  - Typically ad hoc group of investors
  - Company pays advisory fees of ad hoc group
- Period for diligence and negotiation of deal terms
  - Restricted v. Unrestricted Investors
  - Herding of the cats – the art of the deal
- Support Agreement (f/k/a "Lockup Agreement")
  - Binds investors to tender/vote in favor of deal
  - Commits company (subject to fiduciary duties) to forge ahead

## Prepack Process

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- Draft substantial plan & disclosure documents
- Launch Solicitation
- Comply with applicable securities laws
- Comply with bankruptcy solicitation/disclosure requirements
  - Solicit all beneficial owners
  - No side deals
- Obtain requisite consents
- File for chapter 11
- Seek court confirmation
- Consummation of plan (exit bankruptcy)

## Prenegotiated Plans

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- Arise when
  - there is no time for the prepack (e.g., liquidity too tight)
  - insufficient supporting creditors, and/or
  - need to accomplish a goal that prepack is ill-suited to implement (e.g., impair non-financial debt claims)
- Numerous varieties
  - Prenegotiated with Support Agreements
  - Prenegotiated with Term Sheet
  - Prenegotiated with Vision

## Prenegotiated Plans

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- Strongest Variety
  - key creditor constituency fully committed via support agreement with requisite vote to support plan
- Weakest Variety
  - simply a public relations stunt to temper impact of bankruptcy by stating that the company has a vision supported by a nonbinding creditor constituency

## Prenegotiated Plans

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- Benefits
  - Committed creditor support toward a concrete exit strategy
  - Lessens impact on business by providing vision to customers
  - Should limit time in bankruptcy and attendant cost
- Risks
  - Riskier than prepack because vote not in hand
  - Lock-Up period can be lengthy (many more "outs" for creditor)
  - Longer stay in bankruptcy and attendant risk of material change on business/assets/management support
  - New Players – creditors committee and disgruntled creditors have ability to materially influence process and derail exit strategy

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# Prepackaged and Prenegotiated Chapter 11 Reorganizations

## Evaluating the Benefits and Risks of Pre-Bankruptcy Restructuring Plans

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# Delaware General Corporation Law (“DGCL”) §§ 102(b)(2) and 302

## ■ Overview

- ❑ Sections 102(b)(2) and 302 provide for court approval of a restructuring, called a “compromise or arrangement” (a “Delaware compromise”)
- ❑ Delaware law equivalent of a prepackaged bankruptcy under the Bankruptcy Code
- ❑ Like an approved prepackaged bankruptcy, an approved Delaware compromise is binding on the petitioning corporation’s creditors and stockholders

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# Benefits and Risks of Using a Delaware Compromise

## ■ Benefits:

1. Speed
2. Lower Cost
3. Potential favourable treatment under Internal Revenue Code (the "I.R.C.")
4. Minimal court supervision over corporate operations
5. Provides bankruptcy relief for those corporations that fail to qualify for Federal bankruptcy relief

## ■ Risks:

1. Uncertainty
  - < 10 compromises under DGCL in the past 30 years
  - No appeal or challenge to an approved compromise under the DGCL
  - Unclear whether a compromise can withstand the challenges of a dissenting creditor or stockholder

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# Benefits of Prepackaged Chapter 11 Reorganizations

## 1. Retention of control

- Less supervision over management decisions by the Bankruptcy court and creditors
- Creditors are less likely to force the debtor to replace members of senior management

# Benefits of Prepackaged Reorganizations (cont.)

## 2. Less time spent in Chapter 11 bankruptcy

- Chapter 11 Reorganizations 1980-2009: Number of Days from Filing to Confirmation

### Days to Confirmation

<b>Type of Chapter 11 Reorganization</b>	<i>Mean</i>	<i>Median</i>	<i>Std. Dev.</i>	<i>Frequency</i>
<i>Nonprepackaged/ Nonprenegotiated</i>	684	551	470	446
<i>Prepackaged</i>	66	44	98	68
<i>Prenegotiated</i>	226	159	252	110

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## Prepack Case Examples – Days elapsed from petition to confirmation

- On June 1, 2009, Judge Christopher Sontchi of the U.S. Bankruptcy Court for the District of Delaware confirmed the prepackaged reorganization plan of finance company J.G. Wentworth LLC. The confirmation came 13 days after J.G. Wentworth's May 19 Chapter 11 filing.
- Two of the fastest prepacks:
  - *In re Blue Bird Body Co.*, No. 06-50026 (Bankr. D. Nev. Jan. 27, 2006): Prepackaged Chapter 11 reorganization filed on January 26, 2006 and confirmed the following day.
  - *In re Davis Petroleum Corp.*, No. 06-20152 (Bankr. S.D. Texas Mar. 10, 2006): Prepackaged Chapter 11 reorganization filed on March 7, 2006 and confirmed three days later.

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# Benefits of Prepackaged Reorganizations (cont.)

## 3. Less effect on business operations

- Avoids customer drain/competitive disadvantage
- Debtors have continued access to existing credit

## 4. High probability of obtaining a successful Chapter 11 plan

- Major creditors on board with plan prior to filing date

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# Benefits of Prepackaged Reorganizations (cont.)

## 5. Reduced administrative expenses

- Fewer Bankruptcy Code provisions with which to comply
- Post-BAPCPA section 341(e) eliminates requirement that court must schedule a meeting of the creditors committee

\*\*\*Qualification: Some economic benefit reduced given:

- Substantial time spent negotiating with creditors prepetition
- The fact that the debtor typically pays the fees and expense of an *ad hoc* committee's advisors without bankruptcy court oversight on reasonableness

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# Risks of Prepackaged Chapter 11 Reorganizations

1. Court approval of solicitation
  - Court could require re-solicitation and a new vote
2. No automatic stay protection during negotiations
  - “[P]ursuant to section 362(a), the automatic stay prohibits the commencement or continuation of lawsuits, attachment or execution of judgments against property of the debtor and foreclosure on collateral.”
3. Cannot reject executory contracts until filing
4. Bar date issues
  - Short time between commencement of Chapter 11 case and confirmation hearing

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# Risks of Prepackaged Reorganizations (cont.)

5. Advance notice to creditors of plan to file Chapter 11 case

- Creditors may force an involuntary bankruptcy
- Creditors may stop supplying credit

6. Unliquidated or contingent claims are difficult to determine outside of a Chapter 11 case

7. Potential problems with equity holders

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# Risks of Prepackaged Reorganizations

(cont.)

## 8. May not have the benefit of sections 1125(e) or 1145 of the Bankruptcy Code

- SEC “no action” letters indicate that prepacks may not utilize the section 1145 exemption from registration
- Section 1125(e) provides a safe harbor for good faith solicitations of votes on a Chapter 11 plan – protects debtors against liability for state and federal securities laws (i.e., Securities Act of 1933 and Securities and Exchange Act of 1934)
  - Unclear whether the section applies to prepetition solicitations – section is titled “Postpetition disclosure and solicitation”
  - However, commentators have argued that the safe harbor does apply

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## Company Characteristics Indicating Higher Probability of Prepack Success

- Previous out-of-court workout failed due to minority holdouts, or
- Substantial prepetition negotiations with key creditors possible and,
- Small number of affected creditors
- Also beneficial if unsecured creditors are unimpaired by the prepack
  - Eliminates a class of creditors as a source of objection to the reorganization plan
- Prepetition solicitation and voting is less suitable for complex cases with multiple classes of creditors

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# Benefits of Prenegotiated Chapter 11 Reorganizations

1. Shorter time spent in bankruptcy
  - Although longer than prepack (see chart above)
2. Greater certainty of obtaining a successful Chapter 11 case
  - Debtor conducts solicitation and voting after court approval of the disclosure statement is received
  - Solicitation and approval are conducted under the protection of the Bankruptcy Code
3. Lower expense than a traditional Chapter 11 case

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# Benefits of Prenegotiated Reorganizations (cont.)

4. No need to comply with nonbankruptcy securities laws during solicitation process
  - By prenegotiating but not presoliciting acceptances for a reorganization plan, debtor avoids SEC review of disclosure documents
5. Useful if creditors are “knocking at the door”
  - Debtor does not have sufficient time to thoroughly negotiate and solicit acceptances for each point of a prepackaged plan
  - Debtor can confirm principal terms with major creditors and work out the rest of the plan in bankruptcy under the protection of the automatic stay

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# Risks of Prenegotiated Chapter 11 Reorganizations

## 1. Less certainty of obtaining a successful reorganization plan

- No solicitation or voting before filing
- Bankruptcy court may find the lock-up agreement insufficient and the parties may not be bound by its terms
  - *See In re Stations Holding Co.*, No. 02-10882 (Bankr. D. Del. Oct. 25, 2002) (Bankruptcy court found lock-up agreement executed postpetition unenforceable)

## 2. No automatic stay protection during prepetition negotiations

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# Risks of Prenegotiated Reorganizations (cont.)

## 3. Uncertainty as to ability to serve on official committees

- Some courts will not allow creditors who signed lock-up agreements to serve on unsecured creditors' committee
- *See In re NII Holdings, Inc.*, No. 02-11505 (Bankr. D. Del. Oct. 25, 2002) (Bankruptcy court found fully executed prepetition lock-up enforceable, but creditors executing lockup disqualified from serving on the official committee)
- Possibility that the official committee will be comprised of creditors that do not support the plan